



STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

450 N STREET, SACRAMENTO, CALIFORNIA  
PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-0043  
(916) 445-1441 • FAX (916) 322-7175  
[www.boe.ca.gov](http://www.boe.ca.gov)

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JOHN CHIANG  
State Controller

KRISTINE CAZADD  
Executive Director

February 17, 2012

Dear Interested Party:

Enclosed are the Agenda, Issue Paper, and Revenue Estimate for the February 28, 2012 Business Taxes Committee meeting. This meeting will address the proposed amendments to Regulation 1684, *Collection of Use Tax by Retailers*.

Action 1 on the Agenda concerns proposed amendments to Regulation 1684 to implement, interpret, and make specific the provisions of amended Revenue and Taxation Code section 6203 regarding the definition of a “retailer engaged in business in this state.” Please feel free to publish this information on your website or otherwise distribute it to your associates, members, or other persons that may be interested in this issue.

Thank you for your input on these issues and I look forward to seeing you at the Business Taxes Committee meeting at **10:00 a.m. on February 28, 2012** in Room 121 at the address shown above.

Sincerely,

Jeffrey L. McGuire, Deputy Director  
Sales and Use Tax Department

JLM: rsw

Enclosures

cc: (all with enclosures)

Honorable Jerome E. Horton, Chairman, Fourth District  
Honorable Michelle Steel, Vice Chair, Third District  
Honorable Betty T. Yee, Member, First District (MIC 71)  
Senator George Runner (Ret.), Member, Second District (MIC 78)  
Honorable John Chiang, State Controller, c/o Ms. Marcy Jo Mandel

(via email)

Mr. Robert Thomas, Board Member's Office, Fourth District

Mr. Neil Shah, Board Member's Office, Third District

Mr. Tim Treichelt, Board Member's Office, Third District

Mr. Alan LoFaso, Board Member's Office, First District

Ms. Mengjun He, Board Member's Office, First District

Mr. James Kuhl, Board Member's Office, Second District

Mr. David Duran, Member's Office, Second District

Mr. Lee Williams, Board Member's Office, Second District

Ms. Natasha Ralston Ratcliff, State Controller's Office

Ms. Kristine Cazadd

Mr. Randy Ferris

Ms. Christine Bisauta

Mr. Bradley Heller

Mr. Robert Tucker

Ms. Susanne Buehler

Ms. Kirsten Stark

Ms. Leila Hellmuth

Mr. Robert Wilke

**AGENDA — February 28, 2012 Business Taxes Committee Meeting**  
**Regulation 1684, *Collection of Use Tax by Retailers***

<p><b>Action 1 – Proposed amendments to Regulation 1684, <i>Collection of Use Tax by Retailers</i></b></p> <p>Issue Paper Alternative 1 – Staff Recommendation</p> <p>See Agenda, pages 2 – 10, and Issue Paper Exhibit 2.</p> <p>Issue Paper Alternative 2 – Do not amend Regulation 1684.</p>	<p><b>Alternative 1</b></p> <p>Approve and authorize publication of staff’s proposed amendments to implement, interpret, and make specific the amendments made to Revenue and Taxation Code section 6203 by section 3 of Assembly Bill No. 155 (Stats. 2011, ch. 313), which will change the definition of “retailer engaged in business in this state” operative September 15, 2012, or January 1, 2013.</p> <p><b>OR</b></p> <p><b>Alternative 2</b></p> <p>Do not amend the regulation.</p>
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# AGENDA — February 28, 2012 Business Taxes Committee Meeting

## Regulation 1684, *Collection of Use Tax by Retailers*

<b>Action 1 – Staff Recommendation</b>	<p>(a) <u>Collection of Use Tax by Retailers Engaged in Business in this State.</u> Retailers engaged in business in this state as defined in Section 6203 of the Revenue and Taxation Code and making sales of tangible personal property, the storage, use, or other consumption of which is subject to the tax must register with the Board and, at the time of making the sales, or, if the storage, use or other consumption of the tangible personal property is not then taxable, at the time it becomes taxable, collect the tax from the purchaser and give the purchaser a receipt therefor.</p> <p>(b) <u>General Definition and Rebuttable Presumption.</u></p> <p style="padding-left: 40px;">(1) <u>A retailer is engaged in business in this state as defined in section 6203 of the Revenue and Taxation Code if the retailer has a substantial nexus with this state for purposes of the Commerce Clause (art. I, § 8, cl. 3) of the United States Constitution or federal law otherwise permits this state to impose a use tax collection duty on the retailer. Retailers engaged in business in this state include, but are not limited to, retailers described in subdivision (c).</u></p> <p style="padding-left: 40px;">(2) <u>Except as provided in subdivisions (c) and (d), there is a presumption that a retailer is engaged in business in this state as defined in section 6203 of the Revenue and Taxation Code if the retailer has any physical presence in California. A retailer may rebut the presumption if the retailer can substantiate that its physical presence is so slight that the United States Constitution prohibits this state from imposing a use tax collection duty on the retailer.</u></p> <p style="padding-left: 40px;">(3) <u>A retailer does not have a physical presence in California solely because the retailer engages in interstate communications with customers in California via common carrier, the United States mail, or interstate telecommunication, including, but not limited to, interstate telephone calls and emails. The rebuttable presumption in subdivision (b)(2) does not apply to a retailer that does not have a physical presence in California.</u></p> <p>(c) <u>Nonexhaustive Examples of Retailers Engaged in Business in this State.</u></p> <p style="padding-left: 40px;">(1) <u>A retailer is engaged in business in this state as defined in section 6203 of the Revenue and Taxation Code if:</u></p>
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# **AGENDA — February 28, 2012 Business Taxes Committee Meeting** **Regulation 1684, Collection of Use Tax by Retailers**

<p><b>Action 1 – Staff Recommendation</b></p>	<p><u>(A) The retailer owns or leases real or tangible personal property, including, but not limited to, a computer server, in California; or</u></p> <p><u>(B) <del>Any</del>The retailer derivingderives rentals from a lease of tangible personal property situated in California (under such circumstances this state is a “retailer engaged in business in this state” andthe retailer is required to collect the tax at the time rentals are paid by <del>the</del>his lessee);</u></p> <p><u>(C) The retailer maintains, occupies, or uses, permanently or temporarily, directly or indirectly, or through a subsidiary, or agent, by whatever name called, an office, place of distribution, sales or sample room or place, warehouse or storage place, or other place of business in California; or</u></p> <p><u>(D) The retailer has a representative, agent, salesperson, canvasser, independent contractor, solicitor, or any other person operating in California on the retailer’s behalf, including a person operating in California under the authority of the retailer or its subsidiary, for the purpose of selling, delivering, installing, assembling, or the taking of orders for any tangible personal property, or otherwise establishing or maintaining a market for the retailer’s products.</u></p> <p><u>(2) A retailer is engaged in business in this state as defined in section 6203 of the Revenue and Taxation Code if:</u></p> <p><u>(A) The retailer is a member of a commonly controlled group, as defined in Revenue and Taxation Code section 25105; and</u></p> <p><u>(B) The retailer is a member of a combined reporting group, as defined in California Code of Regulations, title 18, section 25106.5, subdivision (b)(3), that includes another member of the retailer’s commonly controlled group that, pursuant to an agreement with or in cooperation with the retailer, performs services in California in connection with tangible personal property to be sold by the retailer, including, but not limited to, design and development of tangible personal property sold by the retailer, or the solicitation of sales of tangible personal property on behalf of the retailer. For purposes of this paragraph:</u></p> <p><u>(i) Services are performed in connection with tangible personal property to be sold by a retailer if the services help the retailer establish or maintain a California market for sales of tangible personal property; and</u></p>
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# AGENDA — February 28, 2012 Business Taxes Committee Meeting

## Regulation 1684, *Collection of Use Tax by Retailers*

<p><b>Action 1 – Staff Recommendation</b></p>	<p><u>(ii) Services are performed in cooperation with a retailer if the retailer and the member of the retailer’s commonly controlled group performing the services are working or acting together for a common purpose or benefit.</u></p> <p><u>(3) A retailer is engaged in business in this state as defined in section 6203 of the Revenue and Taxation Code if the retailer enters into an agreement or agreements under which a person or persons in this state, for a consideration that is based upon completed sales of tangible personal property, whether referred to as a commission, fee for advertising services, or otherwise, directly or indirectly refer potential purchasers of tangible personal property to the retailer, whether by an Internet-based link or an Internet website, or otherwise, provided that:</u></p> <p><u>(A) The total cumulative sales price of all of the tangible personal property the retailer sold to purchasers in California that were referred to the retailer by a person or persons in California pursuant to an agreement or agreements described above, in the preceding 12 months, is in excess of ten thousand dollars (\$10,000); and</u></p> <p><u>(B) The retailer, within the preceding 12 months, has total cumulative sales of tangible personal property to purchasers in California in excess of one million dollars (\$1,000,000).</u></p> <p><u>The determination as to whether a retailer has made the requisite amount of sales to purchasers in California during the preceding 12-month period shall be made at the end of each calendar quarter. A retailer is not engaged in business in this state pursuant to this paragraph if the total cumulative sales price of all of the tangible personal property the retailer sold to purchasers in California that were referred to the retailer by a person or persons in California pursuant to an agreement or agreements described above, in the preceding 12 months, is not in excess of ten thousand dollars (\$10,000), or if the retailer’s total cumulative sales of tangible personal property to purchasers in California were not in excess of one million dollars (\$1,000,000) in the preceding 12 months.</u></p> <p><u>For purposes of this paragraph, the term “retailer” includes an entity affiliated with a retailer within the meaning of Internal Revenue Code section 1504, which defines the term “affiliated group” for federal income tax purposes.</u></p>
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# **AGENDA — February 28, 2012 Business Taxes Committee Meeting** **Regulation 1684, *Collection of Use Tax by Retailers***

<p><b>Action 1 – Staff Recommendation</b></p>	<p><u>(4) Paragraph (3) does not apply to an agreement under which a retailer purchases advertisements from a person in California, to be delivered on television, radio, in print, on the Internet, or by any other medium, unless:</u></p> <p><u>(A) The advertisement revenue paid to the person in California consists of commissions or other consideration that is based upon completed sales of tangible personal property, and</u></p> <p><u>(B) The person entering into the agreement with the retailer also directly or indirectly solicits potential customers in California through the use of flyers, newsletters, telephone calls, electronic mail, blogs, microblogs, social networking sites, or other means of direct or indirect solicitation specifically targeted at potential customers in this state.</u></p> <p><u>(5) For purposes of paragraph (3):</u></p> <p><u>(A) A person that is an individual is in this state when the person is physically present within the boundaries of California; and</u></p> <p><u>(B) A person other than an individual is in this state when there is at least one individual physically present in California on the person’s behalf.</u></p> <p><u>(6) Paragraph (3) does not apply to a retailer’s agreement with any person, unless an individual solicits potential customers under the agreement while the individual is physically present within the boundaries of California, including, but not limited to, an individual who entered into the agreement directly with the retailer, an individual, such as an employee, who is performing activities in California directly for a person that entered into the agreement with the retailer, and any individual who is performing activities in California indirectly for any person who entered into the agreement with the retailer, such as an independent contractor or subcontractor.</u></p> <p><u>(7) Paragraph (3) does not apply if a retailer can demonstrate that all of the persons with whom the retailer has agreements described in paragraph (3) did not directly or indirectly solicit potential customers for the retailer in California. A retailer can demonstrate that an agreement is not an agreement described in paragraph (3) if:</u></p>
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# AGENDA — February 28, 2012 Business Taxes Committee Meeting

## Regulation 1684, *Collection of Use Tax by Retailers*

<p><b>Action 1 – Staff Recommendation</b></p>	<p><u>(A) The retailer’s agreement:</u></p> <p><u>(i) Prohibits persons operating under the agreement from engaging in any solicitation activities in California that refer potential customers to the retailer including, but not limited to, distributing flyers, coupons, newsletters and other printed promotional materials or electronic equivalents, verbal soliciting (e.g., in-person referrals), initiating telephone calls, and sending e-mails; and</u></p> <p><u>(ii) If the person in California with whom the retailer has an agreement is an organization, such as a club or a non-profit group, the agreement provides that the organization will maintain on its website information alerting its members to the prohibition against each of the solicitation activities described above;</u></p> <p><u>(B) The person or persons operating under the agreement in California certify annually under penalty of perjury that they have not engaged in any prohibited solicitation activities in California at any time during the previous year, and, if the person in California with whom the retailer has an agreement is an organization, the annual certification shall also include a statement from the organization certifying that its website includes information directed at its members alerting them to the prohibition against the solicitation activities described above; and</u></p> <p><u>(C) The retailer accepts the certification or certifications in good faith and the retailer does not know or have reason to know that the certification or certifications are false or fraudulent.</u></p> <p><u>A retailer is excused from the requirement to obtain a certification if the person from whom the certification is required is dead, lacks the capacity to make such certification, or cannot reasonably be located by the retailer and there is no evidence to indicate that such person did in fact engage in any prohibited solicitation activities in California at any time during the previous year.</u></p> <p><u>(8) For purposes of this subdivision:</u></p> <p><u>(A) “Advertisement” means a written, verbal, pictorial, graphic, etc. announcement of goods or services for sale, employing purchased space or time in print or electronic media, which is given to communicate such information to the general public. Online advertising generated as a result of generic algorithmic functions that is anonymous and passive in nature, such as ads tied to Internet search engines, banner</u></p>
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# AGENDA — February 28, 2012 Business Taxes Committee Meeting

## Regulation 1684, *Collection of Use Tax by Retailers*

<p><b>Action 1 – Staff Recommendation</b></p>	<p><u>ads, click-through ads, Cost Per Action ads, links to retailers’ websites, and similar online advertising services, are advertisements and not solicitations.</u></p> <p><u>(B) “Individual” means a natural person.</u></p> <p><u>(C) “Person” means and includes any individual, firm, partnership, joint venture, limited liability company, association, social club, fraternal organization, corporation, estate, trust, business trust, receiver, assignee for the benefit of creditors, trustee, trustee in bankruptcy, syndicate, the United States, this state, any county, city and county, municipality, district, or other political subdivision of the state, or any other group or combination acting as a unit.</u></p> <p><u>(D) “Solicit” means to communicate directly or indirectly to a specific person or specific persons in California in a manner that is intended to and calculated to incite the person or persons to purchase tangible personal property from a specific retailer or retailers.</u></p> <p><u>(E) “Solicitation” means a direct or indirect communication to a specific person or specific persons done in a manner that is intended to and calculated to incite the person or persons to purchase tangible personal property from a specific retailer or retailers.</u></p> <p><u>(F) “Solicit,” “solicitation,” “refer,” and “referral” do not mean or include online advertising generated as a result of generic algorithmic functions that is anonymous and passive in nature, such as ads tied to Internet search engines, banner ads, click-through ads, Cost Per Action ads, links to retailers’ websites, and similar online advertising services.</u></p> <p><u>(9) Examples:</u></p> <p><u>(A) Corporation X is physically located in California and maintains a website at www.corporationx.com. Corporation X enters into agreements with one or more hiking gear and accessories retailers under which Corporation X maintains click-through advertisements or links to each retailer’s website on Corporation X’s website at www.corporationx.com and Corporation X’s webpage at www.socialnetwork.com/corporationx in return for commissions based upon the retailers’ completed sales made to customers who click-through the ads or links on Corporation X’s website and webpage. Corporation X also posts reviews at www.corporationx.com of the products sold through the click-</u></p>
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# AGENDA — February 28, 2012 Business Taxes Committee Meeting

## Regulation 1684, *Collection of Use Tax by Retailers*

<p><b>Action 1 – Staff Recommendation</b></p>	<p><u>through ads and links on its website and webpage. However, Corporation X does not engage in any solicitation activities in California that refer potential customers to the retailer or retailers who have click-through ads or links on its website or webpage. Therefore, paragraph (3) does not apply to the agreements between Corporation X and the retailer or retailers who have ads or links on Corporation X’s website or webpage.</u></p> <p><u>(B) Same as (A) above, except that Corporation X also enters into an agreement under which Advertising Corporation places advertisements for www.corporationx.com on other businesses’ websites and webpages, and mails or emails advertisements for www.corporationx.com to anyone who signs up to receive such advertisements. However, Corporation X does not engage in any solicitation activities in California that refer potential customers to the retailer or retailers who have click-through ads or links on its website or webpage and Advertising Corporation’s mailers and emails are advertisements, not solicitations. Therefore, paragraph (3) does not apply to the agreements between Corporation X and the retailer or retailers who have ads or links on Corporation X’s website or webpage.</u></p> <p><u>(C) Same as (B) above, except that an individual representative of Corporation X or any other individual acting on behalf of Corporation X, including, but not limited to, an employee or independent contractor of Corporation X or Advertising Corporation, engages in solicitation activities, such as soliciting customers in person, soliciting customers on the telephone, handing out flyers that are solicitations, or sending emails that are solicitations, while physically present in California that refer potential California customers to a retailer who has a click-through ad or link on Corporation X’s website or webpage under Corporation X’s agreement with that retailer. Therefore, paragraph (3) does apply to Corporation X’s agreement with that retailer and that retailer will be required to register with the Board to collect use tax if:</u></p> <p><u>(i) The total cumulative sales price of all of the tangible personal property the retailer sold to purchasers in California that were referred to the retailer by a person or persons in California pursuant to an agreement or agreements described in paragraph (3), in the preceding 12 months, is in excess of ten thousand dollars (\$10,000); and</u></p> <p><u>(ii) The retailer’s total cumulative sales of tangible personal property to purchasers in California is in excess of one million dollars (\$1,000,000) in the preceding 12 months.</u></p>
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**AGENDA — February 28, 2012 Business Taxes Committee Meeting**  
**Regulation 1684, Collection of Use Tax by Retailers**

<p><b>Action 1 – Staff Recommendation</b></p>	<p><u>(d) Exceptions.</u></p> <p><u>(1) Webpages and Internet Service Providers.</u> The use of a computer server on the Internet to create or maintain a World Wide Web page or site by an <del>out-of-state</del> retailer will not be considered a factor in determining whether the retailer has a substantial nexus with California, <u>unless the computer server is located in California and the retailer owns or leases the computer server.</u> No Internet Service Provider, On-line Service Provider, internetwork communication service provider, or other Internet access service provider, or World Wide Web hosting services shall be deemed the agent or representative of any out-of-state retailer as a result of the service provider maintaining or taking orders via a web page or site on a computer server that is physically located in this state.</p> <p><u>(2) Warranty and Repair Services.</u> A retailer is not “engaged in business in this state” based solely on its use of a representative or independent contractor in this state for purposes of performing warranty or repair services with respect to tangible personal property sold by the retailer, provided that the ultimate ownership of the representative or independent contractor so used and the retailer is not substantially similar. For purposes of this paragraph, “ultimate owner” means a stock holder, bond holder, partner, or other person holding an ownership interest.</p> <p><u>(b3) Convention and Trade Show Activities.</u> For purposes of this subdivision, the term “convention and trade show activity” means any activity of a kind traditionally conducted at conventions, annual meetings, or trade shows, including, but not limited to, any activity one of the purposes of which is to attract persons in an industry generally (without regard to membership in the sponsoring organization) as well as members of the public to the show for the purpose of displaying industry products or to stimulate interest in, and demand for, industry products or services, or to educate persons engaged in the industry in the development of new products and services or new rules and regulations affecting the industry.</p> <p>Except as provided in this paragraph, a retailer is not “engaged in business in this state” based solely on the retailer's convention and trade show activities provided that:</p> <p><u>(4A)</u> For the period commencing on January 1, 1998 and ending on December 31, 2000, the retailer, including any of his or her representatives, agents, salespersons, canvassers, independent contractors, or solicitors, does not engage in those convention and trade show activities for more than seven days, in whole or in part, in this state during any 12-month period and did not derive more than ten thousand dollars (\$10,000) of gross income from those activities in this state during the prior calendar year;</p>
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# **AGENDA — February 28, 2012 Business Taxes Committee Meeting** **Regulation 1684, *Collection of Use Tax by Retailers***

<p><b>Action 1 – Staff Recommendation</b></p>	<p>(2B) For the period commencing on January 1, 2001, the retailer, including any of his or her representatives, agents, salespersons, canvassers, independent contractors, or solicitors, does not engage in those convention and trade show activities for more than fifteen days, in whole or in part, in this state during any 12-month period and did not derive more than one hundred thousand dollars (\$100,000) of net income from those activities in this state during the prior calendar year.</p> <p>A retailer coming within the provisions of this subdivision is, however, “engaged in business in this state,” and is liable for collection of the applicable use tax, with respect to any sale of tangible personal property occurring at the retailer's convention and trade show activities and with respect to any sale of tangible personal property made pursuant to an order taken at or during those convention and trade show activities.</p> <p>(ee) Retailers Not Engaged in Business in State. Retailers who are not engaged in business in this state may apply for a Certificate of Registration-Use Tax. Holders of such certificates are required to collect tax from purchasers, give receipts therefor, and pay the tax to the Board in the same manner as retailers engaged in business in this state. As used in this regulation, the term “Certificate of Registration-Use Tax” shall include Certificates of Authority to Collect Use Tax issued prior to September 11, 1957.</p> <p>(df) Use Tax Direct Payment Permit Exemption Certificates. Notwithstanding subdivisions (a) and (bd)(3), a retailer who takes a use tax direct payment exemption certificate in good faith from a person holding a use tax direct payment permit is relieved from the duty of collecting use tax from the issuer on the sale for which the certificate is issued. Such certificate must comply with the requirements of Regulation 1699.6, Use Tax Direct Payment Permits.</p> <p>(eg) Tax as Debt. The tax required to be collected by the retailer and any amount unreturned to the customer which is not tax but was collected from the customer under the representation that it was tax constitute debts owed by the retailer to the state.</p> <p>(fh) Refunds of Excess Collections. Whenever the Board ascertains that a retailer has collected use tax from a customer in excess of the amount required to be collected or has collected from a customer an amount which was not tax but was represented by the retailer to the customer as being use tax, no refund of such amount shall be made to the retailer even though the retailer has paid the amounts so collected to the state. Section 6901 of the Revenue and Taxation Code requires that any overpayment of use tax be credited or refunded only to the purchaser who made the overpayment.</p>
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**AGENDA — February 28, 2012 Business Taxes Committee Meeting**  
**Regulation 1684, *Collection of Use Tax by Retailers***

<b>Action 1 – Staff Recommendation</b>	<p>(i) Amendments. Statutes 2011, chapter 313 (Assem. Bill No. 155), section 3 re-enacted section 6203 of the Revenue and Taxation Code. Chapter 313, section 6, provides that the provisions of section 6203 of the Revenue and Taxation Code as re-enacted by chapter 313, section 3, shall become operative on September 15, 2012, or January 1, 2013. The 2012 amendments to this regulation adopted to implement, interpret, and make specific the provisions of section 6203 of the Revenue and Taxation Code as re-enacted by chapter 313, section 3, shall become operative on the same date as section 6203 of the Revenue and Taxation Code as re-enacted by chapter 313, section 3. Any amendment that implements, interprets and makes specific a use tax collection obligation that did not exist on June 27, 2011, upon becoming operative, shall not have any retroactive effect.</p>
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Issue Paper Number 12-003



BOARD OF EQUALIZATION  
**KEY AGENCY ISSUE**

- ☐ Board Meeting
- ☒ Business Taxes Committee
- ☐ Customer Services and Administrative Efficiency Committee
- ☐ Legislative Committee
- ☐ Property Tax Committee
- ☐ Other

## Engaged in Business in this State – Obligation to Collect Use Tax

### I. Issue

Whether the Board should amend Sales and Use Tax Regulation (Regulation) 1684, *Collection of Use Tax by Retailers*, to implement, interpret, and make specific the amendments made to Revenue and Taxation Code section 6203 (section 6203) by section 3 of Assembly Bill No. 155 (AB 155) (Stats. 2011, ch. 313), which will change the definition of “retailer engaged in business in this state” operative September 15, 2012, or January 1, 2013?

### II. Alternative 1 - Staff Recommendation

Approve and authorize publication of Board staff’s recommended amendments to Regulation 1684, as set forth in Exhibit 2. After discussing AB 155 with the interested parties and reviewing the interested parties’ comments, Board staff recommends that Regulation 1684 be amended to:

- Incorporate the new provisions of section 6203, subdivision (c), as amended by AB 155 (new subdivision (c)), providing that “retailer engaged in business in this state” means “any retailer that has substantial nexus with this state for purposes of the commerce clause of the United States Constitution and any retailer upon whom federal law permits this state to impose a use tax collection duty”;
- Incorporate the non-exhaustive examples of retailers with substantial nexus set forth in new subdivision (c), including the examples regarding commonly controlled group nexus and affiliate nexus;
- Incorporate the physical presence test established in *National Bellas Hess, Inc. v. Department of Revenue of the State of Illinois* (1967) 386 U.S. 753 (and affirmed in *Quill Corporation v. North Dakota* (1992) 504 U.S. 298) by creating a presumption that a retailer is engaged in business in this state if the retailer has any physical presence in California, and further explain that a retailer may rebut the presumption if the retailer can substantiate that its physical presence is so slight that the United States Constitution prohibits this state from imposing a use tax collection duty on the retailer;
- Explain that a retailer does not have a physical presence in California solely because the retailer engages in interstate communications with customers in California via common carrier, the United States mail, or interstate telecommunication, including, but not limited to, interstate telephone calls and emails, and that the rebuttable presumption does not apply to a retailer that does not have a physical presence in California;
- Clarify that services are performed in connection with tangible personal property to be sold by a retailer if the services help the retailer establish or maintain a California market for sales of tangible personal property, and clarify that services are performed in cooperation with a retailer if the retailer and the member of the retailer’s commonly controlled group performing the services are working or

acting together for a common purpose or benefit for purposes of the commonly controlled group nexus provisions;

- Clarify that the phrases “commission or other consideration” and “commissions or other consideration that is based upon sales of tangible personal property,” as used in the affiliate nexus provisions, refer to any “consideration that is based upon completed sales of tangible personal property, whether referred to as a commission, fee for advertising services, or otherwise”;
- Clarify that the determination as to whether a retailer has made the requisite amount of sales to purchasers in California during the preceding 12-month period to be engaged in business in California under the affiliate nexus provisions shall be made at the end of each calendar quarter;
- Clarify that an individual is in California when the individual is physically present within the boundaries of California and a person other than an individual is in California when there is at least one individual physically present in California on the person’s behalf for purposes of the affiliate nexus provisions;
- Clarify that the affiliate nexus provisions do not apply to a retailer’s agreement with any person, unless an individual solicits potential customers under the agreement while the individual is physically present within the boundaries of California, including, but not limited to, an individual who entered into the agreement directly with the retailer, an individual, such as an employee, who is performing activities in California directly for a person that entered into the agreement with the retailer, and any individual who is performing activities in California indirectly for any person who entered into the agreement with the retailer, such as an independent contractor or subcontractor;
- Create a means by which a retailer can effectively establish that its agreement is not the type of agreement that can give rise to affiliate nexus by utilizing contractual terms and factual certifications, and expressly excuse retailers from the requirement to obtain a certification if the person from whom the certification is required is dead, lacks the capacity to make such certification, or cannot reasonably be located by the retailer and there is no evidence to indicate that such person did in fact engage in any prohibited solicitation activities in California at any time during the previous year;
- Define the terms “advertisement,” “solicit,” and “solicitation” and conform the definitions for the terms “advertisement,” “solicit,” “solicitation,” “refer” and “referral” to the statements of intent published by Senator Hancock and Assembly Members Blumenfield, Calderon, and Skinner in the September 9, 2011, Assembly Daily Journal (the statements are included in Exhibit 3, as discussed below);
- Define the terms “person” and “individual” for purposes of applying the affiliate nexus provisions;
- Provide three examples illustrating the application of the affiliate nexus provisions;
- Recognize that a retailer may establish a substantial nexus with California by having its property, including a computer server, in this state; and
- Provide that the amendments to Regulation 1684 will become operative when new section 6203 becomes operative on September 15, 2012, or January 1, 2013, and shall not have a retroactive effect.

Board staff also recommends that the Board:

- Retain the other current provisions of Regulation 1684 regarding the “taking of orders from customers in this state through a computer telecommunications network” based upon the Board’s 1997 interpretation of *Quill*; and

**FORMAL ISSUE PAPER 12-003**

- Retain the current provisions of Regulation 1684 regarding “warranty and repair services” based upon the Board’s 1997 interpretation of United States Supreme Court cases.

For a more detailed explanation of Alternative 1 - Staff’s Recommendation, refer to section VI beginning on page 19 of this paper.

### **III. Other Alternative Considered**

Do not amend Regulation 1684.



## IV. Background

### Current Regulation 1684 and Current Section 6203

Regulation 1684 requires “[r]etailers engaged in business in this state as defined in Section 6203” to register with the Board, collect California use tax from their California customers, and remit the use tax to the Board. The regulation also provides that such retailers are liable for California use taxes that they fail to collect from their customers and remit to the Board.

### *Current Provisions of Section 6203*

Currently, the operative provisions of section 6203, subdivision (c)(1) through (3), define the term “retailer engaged in business in this state” by providing that:

“Retailer engaged in business in this state” as used in this section and Section 6202 means and includes any of the following:

(1) Any retailer maintaining, occupying, or using, permanently or temporarily, directly or indirectly, or through a subsidiary, or agent, by whatever name called, an office, place of distribution, sales or sample room or place, warehouse or storage place, or other place of business.

(2) Any retailer having any representative, agent, salesperson, canvasser, independent contractor, or solicitor operating in this state under the authority of the retailer or its subsidiary for the purpose of selling, delivering, installing, assembling, or the taking of orders for any tangible personal property.

(3) As respects a lease, any retailer deriving rentals from a lease of tangible personal property situated in this state. (Current section 6203, subd. (c)(1)-(3).)

The current operative provisions of section 6203, subdivision (d)(1), address the taking of orders over the Internet by providing that:

For purposes of this section, “engaged in business in this state” does not include the taking of orders from customers in this state through a computer telecommunications network located in this state which is not directly or indirectly owned by the retailer when the orders result from the electronic display of products on that same network. The exclusion provided by this subdivision shall apply only to a computer telecommunications network that consists substantially of online communications services other than the displaying and taking of orders for products.

In addition, the current operative provisions of section 6203, subdivision (e) provide that a retailer is not a “retailer engaged in business in this state” if that retailer’s “sole physical presence in this state” is to engage in limited convention and trade show activities, as specified.

### *Current Provisions of Regulation 1684*

Currently, Regulation 1684 does not define the full scope of the phrase “engaged in business in this state as defined in Section 6203.” Instead, Regulation 1684, subdivision (a), provides, in relevant part, the following guidance regarding the meaning of “engaged in business in this state” as currently defined by section 6203, subdivisions (c) and (d):

Any retailer deriving rentals from a lease of tangible personal property situated in this state is a “retailer engaged in business in this state” and is required to collect the tax at the time rentals are paid by his lessee.

The use of a computer server on the Internet to create or maintain a World Wide Web page or site by an out-of-state retailer will not be considered a factor in determining whether the retailer has a substantial nexus with California. No Internet Service Provider, On-line Service Provider, internetwork communication service provider, or other Internet access service provider, or World Wide Web hosting services shall be deemed the agent or representative of any out-of-state retailer as a result of the service provider maintaining or taking orders via a web page or site on a computer server that is physically located in this state.

A retailer is not “engaged in business in this state” based solely on its use of a representative or independent contractor in this state for purposes of performing warranty or repair services with respect to tangible personal property sold by the retailer, provided that the ultimate ownership of the representative or independent contractor so used and the retailer is not substantially similar. For purposes of this paragraph, “ultimate owner” means a stock holder, bond holder, partner, or other person holding an ownership interest.

Regulation 1684, subdivision (b), also incorporates the current provisions of section 6203, subdivision (e) regarding convention and tradeshow activities.

#### Section 6203 as Amended by AB 155

Section 6203, subdivision (c), as amended by AB 155, will define the term “retailer engaged in business in this state” more broadly than current section 6203, subdivision (c), and provide that the term means “any retailer that has substantial nexus with this state for purposes of the commerce clause of the United States Constitution and any retailer upon whom federal law permits this state to impose a use tax collection duty.”

Section 6203, subdivision (c)(1) through (3), as amended by AB 155, will provide that the term “retailer engaged in business in this state” specifically includes, but is not limited to, retailers engaged in the activities described in current section 6203, subdivision (c)(1) through (3) (quoted above). Subdivision (c)(4), as added to section 6203 by AB 155, will further provide that “retailer engaged in business in this state” specifically includes, but is not limited to, any retailer that is a member of a “commonly controlled group” as defined in section 25105 of the Revenue and Taxation Code, and is a member of a “combined reporting group,” as defined by the Franchise Tax Board (FTB) in California Code of Regulations, title 18, section 25106.5, subdivision (b)(3), “that includes another member of the retailer’s commonly controlled group that, pursuant to an agreement with or in cooperation with the retailer, performs services in this state in connection with tangible personal property to be sold by the retailer . . . .”

In addition, subdivision (c)(5)(A), as added to section 6203 by AB 155, will provide that the term “retailer engaged in business in this state” specifically includes, but is not limited to “[a]ny retailer entering into an agreement or agreements under which a person or persons [e.g., an affiliate or affiliates] in this state, for a commission or other consideration, directly or indirectly refer potential purchasers of tangible personal property to the retailer, whether by an Internet-based link or an Internet Web site, or otherwise,” but only if: (1) “The total cumulative sales price from all of the retailer’s sales, within the

preceding 12 months, of tangible personal property to purchasers in this state that are referred pursuant to all of those agreements with a person or persons in this state, is in excess of ten thousand dollars (\$10,000)”; and (2) “The retailer, within the preceding 12 months, has total cumulative sales of tangible personal property to purchasers in this state in excess of one million dollars (\$1,000,000).”

However, subdivision (c)(5)(B), as added to section 6203 by AB 155, will provide that: “An agreement under which a retailer purchases advertisements from a person or persons in this state, to be delivered on television, radio, in print, on the Internet, or by any other medium, is not an agreement described in subparagraph (A), unless the advertisement revenue paid to the person or persons in this state consists of commissions or other consideration that is based upon sales of tangible personal property.” Subdivision (c)(5)(C), as added to section 6203 by AB 155, will provide that: “Notwithstanding subparagraph (B), an agreement under which a retailer engages a person in this state to place an advertisement on an Internet Web site operated by that person, or operated by another person in this state, is not an agreement described in subparagraph (A), unless the person entering the agreement with the retailer also directly or indirectly solicits potential customers in this state through use of flyers, newsletters, telephone calls, electronic mail, blogs, microblogs, social networking sites, or other means of direct or indirect solicitation specifically targeted at potential customers in this state.” Subdivision (c)(5)(D), as added to section 6203 by AB 155, will provide that for purposes of paragraph (c)(5), “retailer” includes “an entity affiliated with a retailer within the meaning of Section 1504 of the Internal Revenue Code.” Also, subdivision (c)(5)(E), as added to section 6203 by AB 155, will provide that paragraph (c)(5) “shall not apply if the retailer can demonstrate that the person in this state with whom the retailer has an agreement did not engage in referrals in the state on behalf of the retailer that would satisfy the requirements of the commerce clause of the United States Constitution.”

Finally, it should be noted that the amendments made to section 6203 by AB 155 will also delete the provisions in current section 6203, subdivision (d), regarding the “taking of orders from customers in this state through a computer telecommunications network,” and renumber current section 6203, subdivision (e)’s provisions regarding convention and tradeshow activities as section 6203, subdivision (d).

The amendments made to section 6203 by AB 155 will become operative on September 15, 2012, if a federal law is not enacted on or before July 31, 2012, authorizing the states to require a seller to collect taxes on sales of goods to in-state purchasers without regard to the location of the seller. If a federal law is enacted on or before July 31, 2012, authorizing the states to require a seller to collect taxes on sales of goods to in-state purchasers without regard to the location of the seller, and the state does not, on or before September 14, 2012, elect to implement that law, the amendments made to section 6203 by AB 155 will become operative on January 1, 2013.

## **V. Discussion**

### Physical Presence Test

Article I, section 8, clause 3 of the United States Constitution expressly authorizes the United States Congress to “regulate Commerce with foreign Nations, and among the several States” (Commerce Clause). In *Quill Corporation v. North Dakota* (1992) 504 U.S. 298, the United States Supreme Court explained that:

- The Commerce Clause grants Congress affirmative legislative authority and, by its own force, prohibits certain state actions that interfere with interstate commerce (*Id.* at p. 309);

- Subject to Congress’s legislative authority, the Commerce Clause prohibits a state from requiring a retailer engaged in interstate commerce to collect the state’s use tax unless the retailer has a “substantial nexus” with the state (see *id.* at p. 311);
- In the absence of congressional action, the bright line rule, established in *National Bellas Hess, Inc. v. Department of Revenue of the State of Illinois* (1967) 386 U.S. 753, that a retailer must have a “physical presence” in a taxing state in order for that state to impose a use tax collection obligation on the retailer is still applicable today (see *id.* at pp. 317-318); and
- *National Bellas Hess* interpreted the Commerce Clause as establishing a “safe harbor” prohibiting a state from requiring a retailer to collect that state’s use tax if the retailer’s only connection with customers in the state is by common carrier or the United States mail, which, in the absence of congressional action, is still applicable today (see *id.* at p. 315).

Historically, the United States Supreme Court has agreed that the safe harbor established in *National Bellas Hess* (and reaffirmed in *Quill*) is limited and does not apply when a retailer’s “connection with the taxing state is not exclusively by means of the instruments of interstate commerce.” (*National Geographic Society v. California Board of Equalization* (1977) 430 U.S. 551, 556 [quoting from and affirming the California Supreme Court’s decision in *National Geographic Society v. State Board of Equalization* (1976) 16 Cal.3d 637, 644].) The United States Supreme Court has specifically found that the safe harbor does not apply to an out-of-state retailer that has established a place of business in the taxing state, even if the retailer’s in-state business activities are unrelated to the retailer’s sales of tangible personal property to customers in that state. (*Id.* at p. 560.) The United States Supreme Court has specifically explained that the safe harbor does not apply if a retailer attempts to negate its connections with a taxing state by organizing itself or its activities in such a way as to “departmentalize” its connection with the taxing state so that the connection is isolated from the retailer’s obvious selling activities. (*Id.* at pp. 560-561.) This is so regardless of whether the connection involves an in-state person who may be characterized as an employee, agent, representative, salesperson, solicitor, broker, or independent contractor, and regardless of whether the activities creating the connection are directly related to the retailer’s sales of tangible personal property to customers in the state. (*Ibid.*; see also *Scripto, Inc. v. Carson Sheriff* (1960) 362 U.S. 207, 211-212.) The United States Supreme Court has also specifically found that the safe harbor does not apply if a retailer has “property within [the taxing] State.” (*National Geographic Society, supra*, 430 U.S. at p. 559 [quoting *National Bellas Hess*].)

Further, the California Supreme Court previously held that “the slightest [physical] presence” in California would be sufficient to create a substantial nexus between a retailer and this state. (*National Geographic Society, supra*, 16 Cal.3d at p. 644.) However, the United States Supreme Court did not agree with the California Supreme Court’s slightest presence standard on appeal (*National Geographic Society, supra*, 430 U.S. at p. 556). Further, the United States Supreme Court subsequently held that a retailer did not have a substantial nexus with a taxing state solely because the retailer licensed a few customers to use software on a few floppy disks located within the taxing state. (*Quill, supra*, 504 U.S. at p. 315, fn. 8.)

More recently, the Court of Appeals of New York (i.e., New York’s highest appellate court) explained that, while the “physical presence” test affirmed in *Quill* requires that a retailer have more than the slightest physical presence in a state before that state can require the retailer to collect the state’s use tax, the physical presence “does not need to be substantial” and “it may be manifested by the presence in the taxing State of the [retailer’s] property or the conduct of economic activities in the taxing State performed by the [retailer’s] personnel or on its behalf.” (*Orvis Co., Inc., v. Tax Appeals Tribunal of the State of New York et al.* (1995) 86 N.Y.2d 165, 178.) Furthermore, the California Court of Appeal expressly

agreed with and followed the Court of Appeals of New York's construction of the physical presence test in *Borders Online, LLC. v. State Board of Equalization* (2005) 129 Cal.App.4th 1179, 1198-1199. And, the California Court of Appeal further explained that activities performed in California by or on behalf of a retailer will be sufficient to satisfy the physical presence test if they enhance the retailer's sales to California customers and significantly contribute to the retailer's ability to establish and maintain a market in California. (*Id.* at p. 1196.)

#### Commonly Controlled Group Nexus

Board staff is aware that, in *Current, Inc. v. State Board of Equalization* (1994) 24 Cal.App.4th 382, the California Court of Appeal concluded that an out-of-state corporate retailer with no stores, solicitors, or property within California does not have a physical presence in California solely because it is acquired by another corporation that is a retailer with a physical presence. However, in that case, the California retailer's activities did not give the out-of-state retailer a physical presence in California because:

- Neither entity was the alter ego or agent of the other for any purpose;
- Neither entity solicited orders for the products of the other, and neither accepted returns of the merchandise of the other or otherwise assisted or provided services for customers of the other;
- Each entity owned, operated, and maintained its own business assets, conducted its own business transactions, hired and paid its own employees, and maintained its own accounts and records;
- Neither entity held itself out to customers or potential customers as being the same as, or an affiliate of, the other;
- Each entity had its own trade name, goodwill, marketing practices and customer lists and marketed its products independently of the other; and
- Neither purchased goods or services from the other. (*Id.* at p. 388.)

Board staff does not believe that the holding in *Current* affects the validity of the provisions of section 6203, subdivision (c)(4), that will become operative on September 15, 2012, or January 1, 2013, which provide that a retailer is engaged in business in California if: (1) the retailer is a member of a commonly controlled group, as defined in section 25105 of the Revenue and Taxation Code; and (2) the retailer is a member of a combined reporting group, as defined in Franchise Tax Board Regulation 25106.5, subdivision (b)(3), that includes "another member of the retailer's commonly controlled group that, **pursuant to an agreement with or in cooperation with the retailer, performs services in this state in connection with tangible personal property to be sold by the retailer**, including, but not limited to, design and development of tangible personal property sold by the retailer, or the solicitation of sales of tangible personal property on behalf of the retailer." (Emphasis added.)

This is because the United States Supreme Court agreed with the Washington Supreme Court, in *Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue* (1987) 482 U.S. 232, 250-251, that a retailer has a substantial nexus with a taxing state if there are persons in that state performing activities on behalf of the retailer that enable the retailer to "establish and maintain a market." In 2005, the California Court of Appeal subsequently quoted *Tyler Pipe* before concluding that an out-of-state retailer organized as a limited liability company (LLC) had a substantial nexus with California because a separate corporation, affiliated with the LLC through a common parent, performed activities in California on behalf of the retailer that were significantly associated with the retailer's ability to establish and maintain its California market. (*Borders Online, supra*, 129 Cal.App.4th at pp. 1196, 1197.) Accordingly, Board staff believes that the California Court of Appeal's holding in *Current* would have been different if the in-state

corporation had performed services in California in connection with tangible personal property to be sold by the out-of-state corporation, pursuant to an agreement with or in cooperation with the out-of-state corporation (i.e., if the provisions of section 6203, subdivision (c)(4) (emphasized above) had been operative and satisfied in that case).<sup>1</sup>

### Affiliate Nexus

The State of New York has enacted an affiliate nexus statute that is similar to the provisions of section 6203, subdivision (c)(5), as amended by AB 155. The New York statute creates a rebuttable presumption that a retailer is soliciting business in New York through an independent contractor or other representative and is required to register to collect New York use tax if the retailer enters into an agreement with a resident of New York under which the resident, for a commission or other consideration, directly or indirectly refers potential customers, whether by a link on an Internet website or otherwise, to the retailer, if the retailer's cumulative gross receipts from sales to customers in New York who were referred to the retailer by residents with the requisite agreements is in excess of \$10,000 during the four proceeding quarters. (N.Y. Tax Law § 1101, subd. (b)(8)(vi).) The New York statute also provides that the presumption may be rebutted by proof that the resident with whom the retailer has an agreement did not engage in any solicitation in the state on behalf of the retailer "that would satisfy the nexus requirement of the United States constitution during the four quarterly periods in question." (*Ibid.*)

Amazon.com LLC filed a lawsuit in New York seeking declaratory and injunctive relief on the ground that the New York statute is unconstitutional on its face because, among other things, it allegedly violates the Commerce Clause; however, when the Supreme Court of New York County (i.e., a New York trial court) denied the relief, Amazon.com LLC dropped its facial challenge and appealed the trial court's decision on other grounds, including the ground that the New York statute allegedly violates the Commerce Clause as applied to Amazon.com LLC. (*Amazon.com, LLC, et al. v. New York State Department of Taxation and Finance* 2010 N.Y. Slip Opn. 7823.) Overstock.com, Inc. also filed a lawsuit in New York seeking injunctive and declaratory relief on the ground that the New York statute is unconstitutional on its face because, among other things, it allegedly violates the Commerce Clause; and when the Supreme Court of New York County denied the relief, Overstock.com, Inc. argued that the statute allegedly violates the Commerce Clause both on its face and as applied to Overstock, Inc. when it appealed the Supreme Court of New York County's decision. (*Overstock.com, Inc. v. New York State Department of Taxation and Finance* 2010 N.Y. Slip Opn. 7823.)

Amazon.com, LLC's and Overstock.com, Inc.'s appeals were consolidated into one matter before the Appellate Division of the Court of Appeals of New York (i.e., an intermediate appellate court) and jointly decided on November 4, 2010. (2010 N.Y. Slip Opn. 7823.) In that decision, the Appellate Division concluded that the New York statute is consistent with the "physical presence" test, which was affirmed in *Quill* and discussed at length in *Orvis*, because it only requires a retailer to register to collect New York use tax if the retailer enters into a business-referral agreement with a New York resident, the resident actively solicits business in New York, as opposed to merely posting a passive advertisement, and the resident receives a commission based upon the sales successfully solicited in New York. (2010 N.Y. Slip Opn. 7823, at pp. 8-10.)

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<sup>1</sup> In its written comments, discussed below, Sutherland Asbill & Brennan LLP disagreed with this statement and asked that it be stricken from a prior discussion paper. However, staff did not strike the statement because staff continues to believe that the provisions of section 6203, subdivision (c)(4), that will become operative on September 15, 2012, or January 1, 2013, are consistent with the holdings in *Tyler Pipe* and *Borders Online*.

Board staff believes that, after remand back to the trial court for further factual development, both Amazon.com, LLC and Overstock.com, Inc. may continue to press their objections to the Appellate Division's decision to the Court of Appeals of New York (i.e., New York's highest appellate court). However, in the meantime, the New York State Department of Taxation and Finance has issued Technical Services Bureau Memorandum TSB-M-08(3)S (May 8, 2008), which explains the rebuttable presumption in the New York statute and provides that the "Tax Department will deem the presumption rebutted where the [retailer] is able to establish that the only activity of its resident representatives in New York State on behalf of the [retailer] is a link provided on the representatives' Web sites to the [retailer's] Web site and none of the resident representatives engage in any solicitation activity in the state targeted at potential New York State customers on behalf of the [retailer]." And, TSB-M-08(3)S further provides that "an agreement to place an advertisement does not give rise to the presumption"; however, "placing an advertisement does not include the placement of a link on a Web site that, directly or indirectly, links to the Web site of a [retailer], where the *consideration for placing the link on the Web site is based on the volume of completed sales generated by the link.*" (Emphasis added.)

The New York State Department of Taxation and Finance also issued Technical Services Bureau Memorandum TSB-M-08(3.1)S (June 30, 2008), which provides that a retailer may rebut the presumption that it has nexus under the New York statute by meeting both of the following conditions:

1. Contract condition – Showing that the contract or agreement between the retailer and the resident representative provides that the resident representative is prohibited from engaging in any solicitation activities in New York that refer potential customers to the retailer, including, but not limited to, distributing flyers, coupons, newsletters and other printed promotional materials, or electronic equivalents, verbal soliciting (e.g., in-person referrals), initiating telephone calls, and sending e-mails, and, if the resident representative is an organization (such as a club or a nonprofit group), showing that the contract or agreement also provides that the organization will maintain on its Web site information alerting its members to the prohibition against each of the solicitation activities described above; and
2. Proof of compliance condition – Showing that each resident representative has submitted to the retailer, on an annual basis, a signed certification stating that the resident representative has not engaged in any prohibited solicitation activities in New York, as described above, at any time during the previous year, and, if the resident representative is an organization, that the annual certification also include a statement from the resident organization certifying that its Web site includes information directed at its members alerting them to the prohibition against each of the solicitation activities described above.

However, as to the proof of compliance condition, a signed certification from a resident representative may only be used to rebut the presumption in the New York statute if the retailer accepts it in good faith (i.e., the retailer does not know or have reason to know that the certificate is false or fraudulent).

In addition, Board staff is aware that subdivision (a)(1) of Regulation 1540, *Advertising Agencies and Commercial Artists*, provides that: "Advertising is commercial communication utilizing one or more forms of communication (such as television, print, billboards, or the Internet) from or on behalf of an identified person to an intended target audience." Board staff is also aware that, in the administrative appeal of Barnes & Noble.com, LLC, the Board had to determine whether certain in-state activity constituted "advertising" or "selling." In the Memorandum Opinion the Board adopted to decide the Barnes & Noble.com appeal, the Board stated that "an 'advertisement' is a 'written, verbal, pictorial, graphic, etc., announcement of goods or services for sale, employing purchased space or time in print or electronic media.'" However, the Board also concluded that when California employees of Barnes &

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Noble Booksellers, Inc. (B&N Booksellers), physically distributed coupons to B&N Booksellers' customers, which could only be used to make discounted purchases from Barnes & Noble.com (B&N.com), the acts of physically distributing the coupons directly to the potential customers of B&N.com were solicitations of those persons, and went beyond mere advertising to the public at large. (Memorandum Opinion, *Barnes & Noble.com*, adopted September 12, 2002.)

Furthermore, Board staff has found that Ballentine's Law Dictionary (3d ed. 2010 LexisNexis) provides that the word "advertise" means "[t]o make known to the public through a medium of publicity that one's goods or services are available for sale or engagement." In addition, Ballentine's Law Dictionary (3d ed. 2010 LexisNexis) defines the word "solicit" as "to invite a business transaction" or "[t]o importune, entreat, implore, ask, attempt, or try to obtain an order" and defines the phrase "solicitation of business" as "seeking orders for goods or services."

### Websites

#### *Enactment of Current Section 6203, Subdivision (d)*

Statutes 1994, chapter 851 (Assem. Bill No. 72, Klehs (AB 72)), section 2 added a new subdivision (k) to section 6203 to provide as follows:

(k) (1) For purposes of this section, "engaged in business in this state" does not include the taking of orders from customers in this state through a computer telecommunications network located in this state which is not directly or indirectly owned by the retailer when the orders result from the electronic display of products on that same network. The exclusion provided by this subdivision shall apply only to a computer telecommunications network that consists substantially of on-line communications services other than the displaying and taking of orders for products.

(2) This subdivision shall become inoperative upon the earlier of the following dates:

(A) The operative date of either (i) provisions of S. 1825 of the 103rd Congress of the United States that authorize states to compel the collection of state sales and use taxes by out-of-state retailers or (ii) substantially similar provisions of another Congressional act.

(B) The date five years from the effective date of the act adding this subdivision.

The legislative digest included in the August 30, 1994, Assembly Floor Analysis of AB 72, provides that "Existing law . . . [m]akes a determination regarding whether or not a retailer is doing business in the state (has 'nexus' in the state) based on a number of factors including: physical location in the state; use of agents in the state; or ownership of a related in-state business." The legislative digest further provides that the provisions of subdivision (k)(1) (above) "[e]xclude from the definition of a retailer 'engaged in business in this state' any electronic display of products or receipt of orders on a computer network located in California, if the network is not owned by the retailer" and "specify that the computer network exception applies only to networks that consist substantially of on-line services other than the display and taking of orders for products." The comments section of the August 30, 1994, analysis of AB 72 also explains that:

Apple Computer is currently developing an on-line home computer network, e.World. The network would like to offer subscribers the ability to shop on-line from Lands End and other direct marketing operations. Apple currently intends to locate the mainframe computer which supports the e.World network in Napa. Subscribers to the network would be connected to the mainframe through modems and phone lines.



The Board of Equalization has indicated to e.World that because of the mainframe's location in California, the board believes that any retailer advertising on the e.World network should be considered to have nexus in-state. Accordingly, the board argues that retailers advertising on the network should be required to collect sales tax both on sales made through e.World and any other sales to consumers in California.

While e.World does not believe that BOE would be able to enforce this position (e.World believes the computer network functions much like a direct seller phone order system which is not subject to tax), the advi[c]e has had a chilling effect on e.World's ability to attract retailers to advertise on the network. Accordingly, absent some clarification of the law, e.World indicates it will likely be forced to relocate the mainframe system outside the state.

This bill makes clear that a retailer who otherwise would not be required to collect sales tax, would not be required to do so simply because they advertise on a computer network which they do not own.

Revenue and Taxation Code section 6203, subdivision (g), was subsequently deleted and subdivision (k) was renumbered as subdivision (j) by Statutes 1995, chapter 555 (Sen. Bill No. 718), section 7 (before eventually being renumbered as current subdivision (d), which does not contain the original sunset provision).

#### *Adoption of Regulation 1684's Current Website Provisions*

The Silicon Valley Software Industry Coalition (Coalition) submitted written comments to the Board for consideration during the July 31, 1997, public hearing regarding proposed amendments to Regulation 1684 to address the use of websites. The Coalition's comments explain that:

[T]he Governor of New York held a press conference [in early 1997] to announce that the mere presence of a company's web site in their state did not constitute nexus for tax purposes in New York. Unfortunately, New York's governor then went on to specifically state that California web-site hosting companies should leave California and relocate in New York, thus implying that California laws created an opposite result. CommerceNet and the Coalition disagreed with New York's interpretation of California's laws and requested the State Board of Equalization to make clear that California's law does not create an incentive for California web-hosting companies to leave California in order to protect their customers from over-reaching tax laws.

As a result of the request, the Board directed staff to prepare a memorandum regarding website nexus and Board staff subsequently submitted Formal Issue Paper 97-005 to the Board for discussion at its April 8, 1997, Business Taxes Committee (BTC) meeting. Formal Issue Paper 97-005 opined that:

In 1993, we received a request for advice regarding a company contemplating starting an on-line computer service similar to on-line service providers. The host computers for the service would be located in California. The company's plan was to offer retailers of tangible personal property the opportunity to place their catalogs on line to be accessed by the on-line company's customers who could also place orders for such tangible personal property over the on-line service. This selling function would not be the primary function of the on-line service; rather, it would consist substantially of on-line

services other than the displaying and taking of orders for products. The company asked whether retailers using the service in this manner to display their catalogs and accept orders through the on-line service would be regarded as retailers engaged in business in California by virtue of this activity.

The company's plan consisted of acting as the out-of-state retailers' representative in this state through its computers located in this state that were used to display tangible personal property for sale and take orders for such property on the out-of-state retailers' behalf. Thus, the staff's conclusion was that the out-of-state retailers would be "engaged in business" in California under subdivision (b) of Revenue and Taxation Code section 6203 by using the company as their representative in this state for purposes of selling tangible personal property.

The company sought relief from the application of subdivision (b) of section 6203 from the Legislature. In cases such as this, if the Legislature chooses to pass legislation, it can do so in several ways. It can pass a statute that simply reverses the interpretation given to the taxpayer. When it does so, it sometimes does so by making the reversal "declaratory of existing law," indicating an intent that the Legislature's provision be retroactive. The Legislature may just make its reversal prospective. The Legislature may, instead of either of these methods, choose to pass a narrowly tailored provision to apply to very specific circumstances. This is what it did in response to the company's request for relief. The Legislature did not pass an outright reversal of the interpretation that a retailer is engaged in business in California if it uses a computer service which is physically located in California to advertise and take orders for sales of tangible personal property. Instead, in narrowly tailored legislation carried by then Assemblyman Johan Klehs, the Legislature adopted subdivision (j) of section 6203 in 1994. The bill was effective September 27, 1994, but became operative on January 1, 1995. (This provision was originally lettered subdivision (k), but has since been relettered (j).) This provision states:

(1) For purposes of this section, 'engaged in business in this state' does not include the taking of orders from customers in this state through a computer telecommunications network located in this state which is not directly or indirectly owned by the retailer when the orders result from the electronic display of products on that same network. The exclusion provided by this subdivision shall apply only to a computer telecommunications network that consists substantially of on-line communications services other than the displaying and taking of orders for products. (Emphasis added in original.)

(2) This subdivision shall become inoperative upon the earlier of the following dates:

(A) The operative date of provisions of a congressional act that authorize states to compel the collection of state sales and use taxes by out-of-state retailers.

(B) The date five years from the effective date of the act adding this subdivision.

This provision applies only to circumstances where the advertising and order-taking is made through a computer telecommunications network which consists substantially of on-line services *other than* the displaying and taking of orders for tangible personal property. Thus, a retailer who displays and takes orders through a computer telecommunications network located in California which does *not* consist substantially of on-line communications services other than the displaying and taking of orders for tangible personal property within the meaning of subdivision (j) of section 6203 arguably should be regarded as engaged in business in California under subdivision (b) of section 6203 (since the subdivision (j) exclusion would not apply). Any other interpretation of subdivision (j) would render it surplusage.

The Legislature effectively stated that this type of activity comes within the definition of “engaged in business” in California of subdivision (b) by adopting a sunset date to the subdivision (j) exclusion to the otherwise applicable provisions of section 6203. Subdivision (j) becomes inoperative in 1999. If this activity did not otherwise come within subdivision (b), there would have been no reason to adopt the narrow subdivision (j) exclusion, nor would there be any reason to have its provisions sunset in 1999. Every provision in a statute must be given meaning whenever possible since the Legislature is presumed not to engage in idle acts. (*Silberg v. Anderson* (1990) 50 Cal.3d 205, 216; *General American Transportation Corp. v. State Bd. of Equalization* (1987) 193 Cal.App.3d 1175, 1181.) Thus, the displaying and taking of orders on a computer located in California brings retailer within subdivision (b) of section 6203. The remaining question is whether the activity comes within the subdivision (j) exclusion from the otherwise applicable provisions of subdivision (b).

However, Mr. Klehs, then Vice Chair of the Board, also distributed his own written comments to the Board on April 8, 1997, for consideration at the BTC meeting that day, which construed the legislative intent underlying the enactment of then subdivision (j). Mr. Klehs’ comments provide that “[t]he legislative intent of AB 72 (Klehs-1994) was to give the BOE staff clear guidance that a retailer is not ‘engaged in business’ in California merely because it maintains a web-site on a third party’s computer which is located in this state, as long as the host computer network consists substantially of services other than displaying and taking of orders for products. In other words, products sold through web sites or over the internet should be treated for nexus purposes the same as mail order or telephone sale products.”

The minutes from the Board’s April 8, 1997, BTC meeting further explain that:

The members unanimously agreed to direct staff to incorporate, for the Board’s consideration to approve publication, the amendment to Regulation 1684 drafted by Dr. Connell and Mr. Andal, with legislative intent provided by Mr. Klehs in the attached memo of April 8, 1997, and support by Mr. Dronenburg for the amending language.

Staff was directed to incorporate the proposed amendment to Regulation 1684 as approved by the members. A draft of those amendments is attached.

The original amendments drafted by Dr. Connell and Mr. Andal provided that: “An out-of-state retailer whose only contact with this state is the use of a computer server on the Internet to create or maintain a World Wide Web page or site does not constitute ‘substantial nexus’ with this state. No Internet Service Provider, On-line Service Provider or other similar provider of Internet access services or World Wide Web hosting services shall be deemed the agent or representative of any out-of-state retailer solely as a result of the service provider maintaining a web page or site on a computer server that is physically

located in this state.” However, during the July 31, 1997, public hearing regarding the adoption of the proposed amendments, the Board directed staff to change the second sentence based upon comments from interested parties so that the second sentence provided that “No Internet Service Provider, On-line Service Provider, internetwork communication service provider, or other Internet access service provider, or World Wide Web hosting services shall be deemed the agent or representative of any out-of-state retailer as a result of the service provider maintaining or taking orders via a web page or site on a computer server that is physically located in this state.” The revised amendments were then adopted on September 10, 1997, and remain part of subdivision (a) of Regulation 1684 today.

The Final Statement of Reasons provides the following factual basis for the adoption of the proposed amendments:

In recent years, two business practices have arisen which raise the issue as to whether or not the retailers practicing them thus became engaged in business in this state. First, some out-of-state retailers have established Web Sites (electronic files maintained on computers called servers) on the World Wide Web, part of the Internet, for the purpose of making sales. The Internet evolved from a Defense Department project in the late 1960's, and has grown to be a world-spanning network of at least 60,000 smaller, independent computer networks linked by satellites, coaxial cable, and phone lines. The World Wide Web is a smaller network of hyperlinked documents within the Internet. (Yahoo! Internet Life (8/97), p. 62) Servers mainly belong to service providers, either Independent Service Providers (ISP's), or national commercial on-line services like Prodigy or America On-Line. The server on which the Web Site is located may or may not be sited in California. Confusion has arisen as to whether or not an in-state ISP who hosts an out-of-state retailer's Web Site is a “representative” within the meaning of Section 6203(b) for use tax collection purposes and, if so, whether the exemption contained in Section 6203(j), whereby nexus is not provided by a retailer's use of an on-line service for the purpose of taking orders for tangible personal property if the primary purpose of the service is not the sale of tangible personal property, applies to a retailer's Web Site carried by a general-interest ISP which hosts a myriad of Web Sites as well as to a proprietary on-line service. Legislation has been introduced to clarify these principles, but none has yet been enacted. As more and more business is being conducted on the Internet, the Board concluded that it was necessary to resolve this issue by regulation to bring some certainty to this area pending legislative action. Upon consultation with industry, the Board concluded that a Web Site is a utility service operating through communications lines to forward a buyer's order to the retailer, so that orders placed through a Web Site should be treated for nexus purposes like orders placed through the mail which the United States Supreme Court has determined does not provide “nexus.” (Quill Corporation v. North Dakota (1992) 504 U.S. 298.) The Board also concluded that the Legislature did intend that Section 6302(j) apply to Web Sites hosted by ISP's as well as to proprietary networks.

As a result, the Board's adoption of the current provisions in Regulation 1684, subdivision (a) regarding the use of websites was based upon the Board's 1997 interpretation of *Quill* and not solely the express language of subdivision (k) of section 6203, as added by AB 72 (currently subdivision (d) of Revenue and Taxation Code section 6203), which will be inoperative on September 15, 2012, or January 1, 2013, due to the provisions of AB 155. However, Board staff is not aware of any published California or federal court case decided before or after 1997 that expressly addresses whether a retailer has substantial nexus with a taxing state when the retailer uses a third party's server in a taxing state or when the retailer

has an Internet Service Provider performing activities on behalf of the retailer in a taxing state. If an out-of-state retailer owns a server in California (as opposed to merely purchasing web services through a third party's servers), under the current (and continuing) provisions of section 6203, subdivision (c)(1), the retailer has a place of business in California where the server is located and is, thus, obligated to collect California use tax. As set forth in more detail below, California's approach to servers is similar to the statutory approaches taken by New York and Washington.

#### *New York's Website Statute*

New York's Technical Services Bureau Memoranda TSB-M-97 (1.1)C Corporation Tax and (1.1)S Sales Tax (November 15, 1999) explain that:

On October 8, 1998, Governor George E. Pataki signed into law new legislation to codify existing state policy with regard to taxation of Internet access, as previously announced in Technical Services Bureau Memoranda TSB-M-97(1)S and TSB-M-97(1)C, which are obsolete and are replaced by this memorandum. This new legislation added sections 12, 179, and 1115(v) to the Tax Law, and is applicable, for sales and compensating use tax purposes, to sales or uses made on or after February 1, 1997.

The provisions of New York Tax Law section 12 provide that:

(a) For purposes of subdivision (b) of this section, the term "person" shall mean a corporation, joint stock company or association, insurance corporation, or banking corporation, as such terms are defined in section one hundred eighty-three, one hundred eighty-four, or one hundred eighty-six, or in article nine-A, thirty-two or thirty-three of this chapter, imposing tax on such entities.

(b) No person shall be subject to the taxes imposed under section one hundred eighty-three, one hundred eighty-four or one hundred eighty-six, or article nine-A, thirty-two or thirty-three of this chapter, solely by reason of (1) having its advertising stored on a server or other computer equipment located in this state (other than a server or other computer equipment owned or leased by such person), or (2) having its advertising disseminated or displayed on the Internet by an individual or entity subject to tax under section one hundred eighty-three, one hundred eighty-four or one hundred eighty-six, or article nine-A, twenty-two, thirty-two or thirty-three of this chapter.

(c) A person, as such term is defined in subdivision (a) of section eleven hundred one of this chapter, *shall not be deemed to be a vendor, for purposes of article twenty-eight of this chapter, solely by reason of (1) having its advertising stored on a server or other computer equipment located in this state (other than a server or other computer equipment owned or leased by such person), or (2) having its advertising disseminated or displayed on the Internet by an individual or entity subject to tax under section one hundred eighty-three, one hundred eighty-four or one hundred eighty-six, or article nine-A, twenty-two, thirty-two or thirty-three of this chapter.*

(d) (i) Except as provided in clause (B) of subparagraph (ii) of paragraph eight of subdivision (b) of section eleven hundred one of this chapter, *a person selling telecommunication services or an Internet access service shall not be deemed to be a vendor, for purposes of article twenty-eight or twenty-nine of this chapter, of tangible personal property or services sold by the purchaser of such telecommunication services or*

*Internet access service solely because such purchaser uses such telecommunication services or Internet access service as a means to sell such tangible personal property or services.*

(ii) For purposes of this subdivision, the term “person” shall refer to any person within the meaning prescribed in either paragraph (c) of subdivision one of section one hundred eighty-six-e of this chapter or subdivision (a) of section eleven hundred one of this chapter, the term “telecommunication services” shall have the meaning prescribed in paragraph (g) of subdivision one of section one hundred eighty-six-e of this chapter, and the term “Internet access service” shall have the meaning prescribed in subdivision (v) of section eleven hundred fifteen of this chapter. (Emphasis added.)

In addition, the provisions of New York Tax Law section 12 enacted in 1998 were not amended when New York enacted its affiliate nexus statute discussed above. Therefore, New York’s policy permitting out-of-state retailers to use third-party servers located in New York to make sales to customers in New York and permitting Internet Service Providers to provide specified in-state services to out-of-state retailers without being required to register to collect New York use tax has been codified in a statute since 1998.

#### *Washington’s Website Statute*

Furthermore, in 2003, the State of Washington added a new statute to its use tax laws to address the use of websites by out-of-state retailers. Paragraphs (5) and (6) of section 82.12.040, title 82 of the Code of Washington, have not been substantially amended since their provisions were enacted in 2003 and currently provide that:

(5) Notwithstanding subsections (1) through (4) of this section, any person making sales is not obligated to collect the tax imposed by this chapter if:

(a) The person’s activities in this state, whether conducted directly or through another person, are limited to:

(i) The storage, dissemination, or display of advertising;

(ii) The taking of orders; or

(iii) The processing of payments; and

(b) The activities are conducted electronically via a web site on a server or other computer equipment located in Washington that is not owned or operated by the person making sales into this state nor owned or operated by an affiliated person. “Affiliated persons” has the same meaning as provided in RCW 82.04.424.

(6) Subsection (5) of this section expires when: (a) The United States congress grants individual states the authority to impose sales and use tax collection duties on remote sellers; or (b) it is determined by a court of competent jurisdiction, in a judgment not subject to review, that a state can impose sales and use tax collection duties on remote sellers.

Therefore, Washington's policy permitting out-of-state retailers to use third-party servers located in Washington to make sales to customers in Washington without being required to register to collect Washington use tax has been codified in a statute since 2003.

### Warranty and Repair Services

Multistate Tax Commission (MTC) Nexus Program Bulletin 95-1 concludes, based upon an analysis of the United States Supreme Court's opinions, that a retailer has a substantial nexus with a taxing state for purposes of imposing a use tax collection obligation if the retailer is providing warranty and repair services in the taxing state through a third-party service provider. Before the MTC issued Bulletin 95-1, the MTC asked the states whether they agreed that the bulletin correctly reflected federal law and each of the individual state's laws and, if so, whether the MTC could include the states' endorsements in the final bulletin, which would subsequently be issued. Based upon the MTC's request, the Board reviewed Bulletin 95-1, and found that it was consistent with California and federal law. Therefore, during its meeting on October 26, 1995, the Board adopted Bulletin 95-1, which was subsequently issued by the MTC in December 1995 with the support of a coalition of 26 states, including California.

However, Mr. Andal distributed a February 13, 1996, memorandum to the Board Members in which he requested that the Board revisit its decision to adopt Bulletin 95-1 because, in his opinion, the bulletin misconstrued federal law and was not consistent with the provisions of section 6203. The Board directed staff to consider and respond to Mr. Andal's comments, and, in March of 1996, the Sales and Use Tax Department presented an issue paper to the Board which provides staff's opinion that Bulletin 95-1 is consistent with both federal and California law, including section 6203. The issue paper also explains that the Board's approval of staff's interpretation of Bulletin 95-1 did not "bind the Board as would a regulation. That is, if a matter arising under enforcement of staff's interpretation of the proper nexus provisions in this area comes before the Board on a petition for redetermination, the Board will have the opportunity to rule on the matter once again with all of the relevant facts before it."

Thereafter, during its meeting on April 10, 1997, the Board unanimously voted to grant the petition of Airway Scale and Manufacturing Company, Inc., in accordance with Mr. Klehs' opinion that a retailer is not engaged in business in California solely because the retailer uses an in-state independent contractor to perform warranty and repair services on behalf of the retailer. And, during the Board's May 6, 1997, BTC meeting, Mr. Dronenburg made a motion to amend Regulation 1684 to include language he drafted to incorporate the above opinion regarding warranty and repair services and the motion was unopposed. Therefore, staff included Mr. Dronenburg's language with the 1997 amendments to Regulation 1684 regarding websites, Mr. Dronenburg's language was subsequently adopted without changes, and this language still remains part of Regulation 1684, subdivision (a) today.

The Final Statement of Reasons provides the following factual basis for the adoption of the proposed 1997 amendments regarding warranty and repair services:

[M]any retailers have entered into contracts with instate businesses to perform repair services on such retailers' products purchased by buyers who are residents of this state.

Again, a controversy has arisen as to whether or not these independent contractors are "representatives" of such retailers within the meaning of Section 6203(b) for use tax collection purposes. Upon researching this issue, the Board determined that such repairmen do not qualify under established United States Supreme Court cases as representatives for nexus purposes because they do not participate in the transfer of the

property from the out-of-state retailer to the in-state customer but, rather, become involved with the property after (sometimes long after) the sale transaction is concluded. As more and more out-of-state retailers are out-sourcing their warranty responsibilities to in-state independent contractors rather than maintaining in-state repair facilities, and no statute addresses this issue, the Board concluded that it was necessary for it to bring certainty to this issue by regulatory action.

As a result, the Board's adoption of the current provisions in Regulation 1684, subdivision (a) regarding warranty and repair services was based upon the Board's 1997 interpretation of United States Supreme Court cases. However, Board staff is not aware of any published California or federal court case decided before or after 1997 that expressly addresses whether a retailer is engaged in business in a taxing state solely because the retailer uses an in-state independent contractor to perform warranty and repair services on behalf of the retailer. We further note that the MTC has not withdrawn Bulletin 95-1.

## VI. Alternative 1 - Staff Recommendation

### Initial Discussion Paper

In the Initial Discussion Paper issued October 14, 2011, Board staff recommended that Regulation 1684 be amended to:

- Incorporate the new provisions of section 6203 regarding substantial nexus, including provisions addressing commonly controlled group nexus and affiliate nexus;
- Incorporate the physical presence test established in *National Bellas Hess* (and affirmed in *Quill*) by creating a rebuttable presumption that, unless otherwise provided in Regulation 1684, a retailer is required to collect California use tax if the retailer has any physical connection to California besides a connection with customers in California that is exclusively by means of interstate commerce, such as by common carrier or the United States mail or interstate telecommunication;
- Define the terms "advertisement," "solicit," and "solicitation" for purposes of applying the new provisions of section 6203 by focusing on the general and broad nature of advertising and the more actively targeted nature of soliciting;
- Explain that the phrases "commission or other consideration" and "commissions or other consideration that is based upon sales of tangible personal property," as used in the new affiliate nexus provisions of section 6203, refer to commissions or other consideration that is based upon completed sales of tangible personal property, similar to the provisions of New York's affiliate nexus statute, as interpreted by TSB-M-08(3)S;
- Create a means by which a retailer can effectively establish that its agreement with a person in California is not the type of agreement that can give rise to affiliate nexus under new section 6203 by utilizing contractual terms and factual certifications that are similar to the contractual terms and factual certifications that a retailer can use to rebut New York's presumption that a retailer has affiliate nexus due to an agreement with a New York resident; and
- Provide that the amendments made to Regulation 1684 to implement the nexus-expanding provisions of AB 155 will become operative when new section 6203 becomes operative on September 15, 2012, or January 1, 2013, and shall not have a retroactive effect.



Board staff also recommended that the Board:

- Retain the current provisions of Regulation 1684 regarding the “taking of orders from customers in this state through a computer telecommunications network” based upon the Board’s 1997 interpretation of *Quill*; and
- Retain the current provisions of Regulation 1684 regarding “warranty and repair services” based upon the Board’s 1997 interpretation of United States Supreme Court cases.

#### Initial Interested Parties Meetings and Comments

Board staff conducted meetings with interested parties on October 31, 2011, in Sacramento, California, and November 2, 2011, in Culver City, California, to discuss the Initial Discussion Paper issued October 14, 2011. Mr. Robert Wils, Mr. Fran Mancina, and Ms. Brenda Narayan of MuniServices, LLC attended the October 31, 2011, meeting and, after the meeting, staff received a written comment from MuniServices, LLC that expressed MuniServices, LLC’s support for staff’s recommended amendments to Regulation 1684. Ms. Michele Pielsticker of Sutherland Asbill & Brennan LLP also attended the October 31, 2011, meeting and asked staff questions about the differences between advertising and soliciting during that meeting. After the meeting, Sutherland Asbill & Brennan LLP submitted written comments regarding staff’s recommended amendments to Regulation 1684. Sutherland Asbill & Brennan LLP’s written comments recommended:

- Revising staff’s recommended amendments adding subdivision (c)(2) to Regulation 1684 to define the phrase “in cooperation with” so that it only refers to “activities performed directly for or on behalf of a retailer,” and clarify that subdivision (c)(2) only applies when a member of an out-of-state retailer’s commonly controlled group is performing in-state “services” that enable the out-of-state retailer to “create or maintain an in-state market”;
- Revising staff’s recommended amendments incorporating the affiliate nexus provisions into Regulation 1684 in order to: (A) define the phrase “person or persons in this state” so that it only refers to “an individual that is a California resident or a business legal entity that is commercially domiciled or headquartered in California”; (B) clarify that “creating a sales and use tax collection obligation based on the presence of an in-state person who refers customers must be limited to those in-state persons who are performing activities to establish or maintain a California market”; (C) clarify the phrase “other consideration”; (D) explain what the phrases “directly or indirectly,” “indirectly solicit,” “indirect solicitation,” and “or otherwise” mean with examples; (E) clarify whether “a static link that is labeled ‘click here’ constitutes a solicitation”; (F) “explain that the method of compensation should not convert an otherwise permissible advertisement into a market-making activity that leads to attributional nexus”; and
- Revising staff’s recommended amendments creating a means by which a retailer can effectively establish that its agreement with a person in California is not the type of agreement that can give rise to affiliate nexus by utilizing contractual terms and factual certifications so that retailers are excused from obtaining certificates where it would be impossible to do so, for example, where the in-state person is deceased.

Sutherland Asbill & Brennan LLP’s written comments also recommended striking Board staff’s recommended amendments to Regulation 1684’s website provisions because, in Sutherland Asbill & Brennan LLP’s opinion, staff’s recommended amendments violate the Internet Tax Freedom Act (ITFA), and striking Board staff’s proposed amendments adding subdivision (b)(2) to Regulation 1684 because, in Sutherland Asbill & Brennan LLP’s opinion, the rebuttable presumption in subdivision (b)(2) is inconsistent with the United States Supreme Court’s view of the Commerce Clause.

Ms. Rebecca Madigan, Executive Director of the Performance Marketing Association, Inc., attended the November 2, 2011, interested parties meeting, and Ms. Madigan made a number of comments regarding the affiliate nexus provisions of section 6203, subdivision (c)(5), as added by AB 155, and staff's initial recommendations to amend regulation 1684 to incorporate those provisions.

First, Ms. Madigan explained that most out-of-state retailers have declined to use New York's procedures for establishing that an advertising agreement with a New York affiliate is not the type of agreement that can create affiliate nexus with New York and cut their ties with their New York affiliates because:

- The direct marketing industry practice is generally to only pay the in-state affiliates commissions based upon completed sales (and with no other compensation) since this is the most cost-effective model for the out-of-state retailers to directly market to in-state customers; and
- The out-of-state retailers are concerned about how they will be treated if and when one of their New York affiliates is found to be soliciting sales in New York in violation of its agreement.

Therefore, Ms. Madigan made a general suggestion that staff consider revising its recommended amendments creating a means by which a retailer can effectively establish that its agreement with a person in California is not the type of agreement that can give rise to affiliate nexus by utilizing contractual terms and factual certifications so that the amendments do not prohibit an advertising agreement from providing for the payment of commissions based upon completed "click-through" sales.

Second, Ms. Madigan explained that the direct marketing industry generally operates through third-party intermediaries. This means that most retailers hire third-party intermediaries whose jobs are to hire the retailers' in-state direct marketing affiliates based upon the terms provided by the retailers, and then track and pay the affiliates' commissions in return for their own percentage of the completed sales generated by the affiliates. Ms. Madigan also explained that one of the largest third-party intermediaries is Commission Junction, Inc., which has its headquarters in California. She further stated that she thought Commission Junction, Inc., would likely leave the state if staff concluded that its intermediary activities can create affiliate nexus for its customers.

In addition, staff received a written comment from the Internet Alliance, NetChoice, AOL, Inc., Yahoo!, Inc., and Google, Inc., which noted that Senator Hancock and Assembly Members Blumenfield, Calderon, and Skinner published statements of intent in the September 9, 2011, Assembly Daily Journal, which clarified that the provisions of section 6203, subdivision (c)(5)(A)-(C), were intended to:

[D]raw a clear line between activities that are "mere advertising" versus more sufficiently meaningful in-state activity that should properly be characterized as "soliciting business" for purposes of meeting the definition of a "retailer engaged in business in this state." Given the evolving nature of online advertising, and the anonymous manner in which it may be delivered to online customers, it is important to note that, in isolation, online advertising, including those ads tied to Internet search engines, banner ads, click-through ads, Cost Per Action ads, links to retailer websites, and similar online advertising services should not be considered a "referral" under subparagraph (5)(A), nor "direct or indirect solicitation specifically targeted at potential customers in the state" under subparagraph (5)(C). Those types of advertising services are generated as a result of generic algorithmic functions and are anonymous and passive in nature and thus do not rise to the level of referring or soliciting business. Agreements for such advertising services are not covered, unless the person entering the agreement also engages in other activities on

behalf of the retailer in this state – such as sending flyers or making phone calls – that are specifically targeted at customers in this state.

The written comment from the Internet Alliance, NetChoice, AOL, Inc., Yahoo!, Inc., and Google, Inc. also recommended revising staff's recommended amendments incorporating the affiliate nexus provisions into Regulation 1684 so that the amendments conform to the statements of intent. (Exhibit 3.)

### Second Discussion Paper

Board staff responded to the interested parties' comments in the Second Discussion Paper issued on December 9, 2011. Board staff generally agreed with Sutherland Asbill & Brennan LLP's suggestions to revise staff's proposed amendments adding subdivision (c)(2) to Regulation 1684 to define the phrase "in cooperation with" and clarify that subdivision (c)(2) only applies when a member of an out-of-state retailer's commonly controlled group is performing in-state "services" that help the out-of-state retailer to establish or maintain a California market for sales of tangible personal property. Therefore, staff recommended that new paragraph (c)(2)(B)(i) be added to Regulation 1684 to provide that "services are performed in connection with tangible personal property to be sold by a retailer if the services help the retailer establish or maintain a California market for sales of tangible personal property." Staff also recommended that new paragraph (c)(2)(B)(ii) be added to Regulation 1684 to define "in cooperation with" in accordance with the general definition of the term, which is that "cooperation" is "an act or instance of working or acting together for a common purpose or benefit." (Dictionary.com.)

Board staff also generally agreed with Sutherland Asbill & Brennan LLP that the phrase "other consideration" should be further clarified. Therefore, Board staff revised its recommended amendments incorporating the affiliate nexus provisions into Regulation 1684 so that they further explain that the consideration referred to in section 6203, subdivision (c)(5), as added by AB 155, is any "consideration that is based upon completed sales of tangible personal property, whether referred to as a commission, fee for advertising services, or otherwise."

Further, Board staff generally agreed with Sutherland Asbill & Brennan LLP's comment that "the method of compensation should not convert an otherwise permissible advertisement into a market-making activity" that creates substantial nexus. Therefore, Board staff revised its recommended amendments explaining how a retailer can effectively establish that its agreement with a person in California is not the type of agreement that can give rise to affiliate nexus so that the amendments do not prohibit an agreement from providing for the payment of commissions, as also suggested by Ms. Madigan.

Moreover, Board staff generally agreed with Sutherland Asbill & Brennan LLP that retailers should be excused from obtaining certificates to establish that their in-state affiliates did not perform prohibited solicitation activities in California under appropriate circumstances, including where the person required to make the certification is deceased. Therefore, Board staff revised its recommended amendments so that the amendments excuse retailers from the requirement to obtain a certification if the person from whom the certification is required is dead, lacks the capacity to make such certification, or cannot reasonably be located by the retailer and there is no evidence to indicate that such person did in fact engage in any prohibited solicitation activities in California at any time during the previous year.

Additionally, Board staff generally agreed with Sutherland Asbill & Brennan LLP that staff's recommended amendments to Regulation 1684 should clarify whether "a static link that is labeled 'click here' constitutes a solicitation. Board staff also agreed with the comment from Internet Alliance,

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NetChoice, AOL, Inc., Yahoo!, Inc., and Google, Inc. that staff's recommended amendments to Regulation 1684 should conform to the statements of intent published by Senator Hancock and Assembly Members Blumenfield, Calderon, and Skinner in the September 9, 2011, Assembly Daily Journal. After reviewing the statements of intent in detail and interpreting the amendments made to section 6203 by AB 155 in light of the statements of intent, staff concluded that:

- The Legislature intended for the new provisions of section 6203, subdivision (c)(5)(A)-(C) "to draw a clear line between activities that are 'mere advertising' versus more sufficiently meaningful in-state activity that should properly be characterized as 'soliciting business' for purposes of meeting the definition of a 'retailer engaged in business in this state.'"
- The Legislature did not intend for section 6203, subdivision (c)(5)(A)'s new affiliate nexus provisions to apply to an agreement under which a retailer purchases online advertising generated as a result of generic algorithmic functions that is anonymous and passive in nature, such as ads tied to Internet search engines, banner ads, click-through ads, Cost Per Action ads, links to retailers' websites, and similar online advertising services. In short, the Legislature has implicitly presumed that persons who enter into this type of agreement with a retailer generally do not directly or indirectly solicit potential customers for the retailer in California.
- Based on the language in subdivision (c)(5)(B) of section 6203, subdivision (c)(5)(A)'s new affiliate nexus provisions *do not apply* to agreements under which a retailer purchases advertisements from a person in this state to be delivered on television, radio, in print, on the Internet, or by any other medium when the advertisement revenue paid to the person *is not based* on commissions or other consideration that is based upon completed sales of tangible personal property. However, the affiliate nexus provisions of subdivision (c)(5)(A) *do apply* to such agreements when the advertisement revenue paid *is based* on commissions or other consideration that is based upon completed sales of tangible personal property.
- Based on the language in subdivision (c)(5)(C) of section 6203, subdivision (c)(5)(A)'s new affiliate nexus provisions *do not apply* to agreements under which a retailer engages a person in this state to place an advertisement on an Internet Web site operated by that person, or operated by another person in this state, if the person entering into the agreement with the retailer *does not* directly or indirectly solicit potential customers in this state through the use of flyers, newsletters, telephone calls, electronic mail, blogs, microblogs, social networking sites, or other means of direct or indirect solicitation specifically targeted at potential customers in this state. However, the affiliate nexus provisions of subdivision (c)(5)(A) *do apply* to such agreements when the person directly or indirectly *does* solicit potential customers in California through such means.

In other words, staff believes the Legislature intended to create a distinction between "traditional" advertising (i.e., involving contracts for the sale of advertising space or time with no presumed solicitation) and "nexus-producing" advertising (i.e., involving commission-based contracts with presumed solicitation).

Therefore, Board staff revised its recommended amendments defining the terms "advertisement," "solicit," and "solicitation" so that the amendments provide that: (1) the term "advertisement" includes the types of online advertising specified in the statements of intent; and (2) the terms "solicit," "solicitation," "refer," and "referral" do not include the types of online advertising specified in the statements of intent. These revisions are intended to ensure that out-of-state retailers who only purchase

“advertisements” as defined in the recommended amendments will not be required to register with the Board to collect use tax as a result of such advertising.

However, Board staff did not agree with all of the interested parties comments. Board staff explained that it believes that the proper administration of the amendments made to section 6203, subdivision (c), by AB 155, requires that the Board establish a presumption that a retailer is “engaged in business in California” if the retailer has any physical connection to California besides a connection with customers in California that is exclusively by means of interstate commerce, such as by common carrier, the United States mail, or interstate telecommunication (i.e., a presumption that a retailer is “engaged in business in California” if the retailer has any in-state physical presence). Retailers can rebut this presumption by establishing that their physical presence in California is so slight that it cannot create a substantial nexus within the meaning of the Commerce Clause. Furthermore, Board staff explained that it believes that the rebuttable presumption set forth in staff’s recommended amendments adding subdivision (b)(2) to Regulation 1684 is consistent with the physical presence test established in *National Bellas Hess* (and reaffirmed in *Quill*) because the presumption only applies when a retailer has a physical presence in California and the presumption that the physical presence creates a substantial nexus and corresponding use tax collection obligation can be rebutted if the retailer can show that its physical presence is so slight that it will not satisfy the physical presence test established in *National Bellas Hess* (and reaffirmed in *Quill*). Therefore, staff did not revise its recommended amendments adding subdivision (b)(2) to Regulation 1684 in response to the above referenced interested parties comments.

Board staff did not agree with Sutherland Asbill & Brennan LLP’s recommendation regarding defining the phrase “person or persons in this state” so that it only refers to “an individual that is a California resident or a business legal entity that is commercially domiciled or headquartered in California.” The term “person” is broadly defined by section 6005 and the recommended definition is inconsistent with that section. Furthermore, an individual does not need to be a resident of California and a legal entity does not need to be headquartered or domiciled in California in order to perform services in this state.

Board staff did not agree with Sutherland Asbill & Brennan LLP’s recommendation to define the terms “directly,” “indirectly,” and “otherwise” because these are all broad terms with generally applicable meanings. However, Board staff indicated that it was open to further discussion regarding adding examples to Regulation 1684 that Sutherland Asbill & Brennan LLP believed would help clarify the meaning of these terms.

Furthermore, Board staff explained that ITFA, as renewed in 2007, imposes a moratorium on the states’ imposition of two categories of taxes during the period beginning November 1, 2003, and ending November 1, 2014:

- Taxes on internet access, which means taxes imposed on a service that enable users to connect to the Internet to access content, information, or other services offered over the Internet, whether imposed on the provider or the consumer; and
- Multiple or discriminatory taxes on electronic commerce. (ITFA §§ 1101(a), 1105(5).)

ITFA provides that the term “tax” includes “the imposition on a seller of an obligation to collect and to remit to a governmental entity any sales or use tax imposed on a buyer by a governmental entity.” (ITFA § 1105(8).) ITFA provides that “[t]he term ‘multiple tax’ means any tax that is imposed by one State or political subdivision thereof on the same or essentially the same electronic commerce that is also subject to another tax imposed by another State or political subdivision thereof (whether or not at the same rate or on the same basis), without a credit (for example, a resale exemption certificate) for taxes paid in other

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jurisdictions.” However, the term “multiple tax” does “not include a sales or use tax imposed by a State and 1 or more political subdivisions thereof on the same electronic commerce or a tax on persons engaged in electronic commerce which also may have been subject to a sales or use tax thereon.” (ITFA § 1105(6)(A) & (B).) ITFA further provides that “The term ‘discriminatory tax’ means –

(A) any tax imposed by a State or political subdivision thereof on electronic commerce that – (i) is not generally imposed and legally collectible by such State or such political subdivision on transactions involving similar property, goods, services, or information accomplished through other means; (ii) is not generally imposed and legally collectible at the same rate by such State or such political subdivision on transactions involving similar property, goods, services, or information accomplished through other means, unless the rate is lower as part of a phase-out of the tax over not more than a 5-year period; (iii) imposes an obligation to collect or pay the tax on a different person or entity than in the case of transactions involving similar property, goods, services, or information accomplished through other means; (iv) establishes a classification of Internet access service providers or online service providers for purposes of establishing a higher tax rate to be imposed on such providers than the tax rate generally applied to providers of similar information services delivered through other means; or

(B) any tax imposed by a State or political subdivision thereof, if – (i) the sole ability to access a site on a remote seller's out-of-State computer server is considered a factor in determining a remote seller's tax collection obligation; or (ii) a provider of Internet access service or online services is deemed to be the agent of a remote seller for determining tax collection obligations solely as a result of – (I) the display of a remote seller's information or content on the out-of-State computer server of a provider of Internet access service or online services; or (II) the processing of orders through the out-of-State computer server of a provider of Internet access service or online services. (ITFA § 1105(2).)

ITFA also provides that except as expressly provided, “nothing in this title shall be construed to modify, impair, or supersede, or authorize the modification, impairment, or superseding of, any State or local law pertaining to taxation that is otherwise permissible by or under the Constitution of the United States or other Federal law and in effect on the date of enactment of this Act.” (ITFA § 1101(b).)

Therefore, Board staff did not agree that its recommended amendments to Regulation 1684’s website provisions violate ITFA. This is because the recommended amendments cannot reasonably be interpreted to impose taxes on Internet access, or multiple or discriminatory taxes within the above ITFA definitions. Board staff also concluded that the recommended amendments merely recognize that a retailer may establish a substantial nexus with California by having its property, including a computer server, in this state. Further, Board staff concluded that the recommended amendments do not discriminate against Internet access providers or electronic commerce retailers because whatever use tax collection obligation may be imposed as a result of the amendments:

- Is generally imposed and legally collectible by California, at the same rate, on transactions involving similar property and goods accomplished through other means involving the presence of a retailer’s property in this state; and
- Will not be imposed on a different person or entity than in the case of transactions involving similar property and goods accomplished through other means.

In addition, Board staff concluded that the recommended amendments will not require a retailer to collect California use tax solely because California consumers can access the retailer's "out-of-State computer server" via the Internet or deem a provider of Internet access service or online services to be the agent of a retailer for determining the retailer's use tax collection obligation solely as a result of the display of the retailer's information or content on "the out-of-State computer server of a provider of Internet access service or online services" or the processing of orders through "the out-of-State computer server of a provider of Internet access service or online services." Therefore, Board staff did not revise its recommended amendments to Regulation 1684 due to Sutherland Asbill & Brennan LLP's comments regarding ITFA.

#### Additional Interested Parties Meetings and Comments

Board staff conducted additional meetings with interested parties on December 20, 2011, in Sacramento, California, and December 22, 2011, in Culver City, California, to discuss the Second Discussion Paper issued December 9, 2011.

Mr. Reed Schreiter attended the December 20, 2011, meeting on behalf of PricewaterhouseCoopers LLP. Mr. Wils and Ms. Narayan attended the December 20, 2011, meeting on behalf of MuniServices, LLC, and Ms. Pielsticker attended the December 20, 2011, meeting on behalf of Sutherland Asbill & Brennan LLP. During the meeting, Ms. Pielsticker explained that she thought the use of the word "connection" in staff's recommended amendments adding subdivision (b)(2) to Regulation 1684 created some confusion as to whether the amendments were consistent with the physical presence test established in *National Bellas Hess* (and reaffirmed in *Quill*) and she expressed interest in adding examples to Regulation 1684 that Sutherland Asbill & Brennan LLP believes will help clarify the meaning of the terms "directly" and "indirectly," although she did not provide specific examples during the meeting. Staff agreed to consider clarifying its recommended amendments adding subdivision (b)(2) to Regulation 1684 and to consider adding clarifying examples to its recommended amendments to Regulation 1684 if any of the interested parties had specific examples for staff to consider.

After the meeting, Sutherland Asbill & Brennan LLP submitted written comments dated January 13, 2012, regarding staff's recommended amendments to Regulation 1684. (Exhibit 4.) Sutherland Asbill & Brennan LLP's written comments recommend that Board staff:

1. Delete the rebuttable presumption from the recommended amendments adding subdivision (b)(2) to Regulation 1684 or replace the reference to "physical connection" with a reference to "physical presence" in the recommended amendments in order to make the rebuttable presumption consistent with the "physical presence" test established in *National Bellas Hess* (and reaffirmed in *Quill*).
2. Further clarify when a person or persons are "in this state" within the meaning of section 6203, subdivision (c)(5)(A), as added by AB 155, and clarify that subdivision (c)(5)(A) only applies to a retailer when there is a person who is conducting referral "activities in California" that help the retailer establish or maintain a California market.
3. Include three examples in the recommended amendments to Regulation 1684 that clarify that the in-state activities described therein will not constitute the "indirect solicitation" of California customers within the meaning of section 6203, subdivision (c)(5)(C), as added by AB 155.
4. Consider adding "unless the computer server located in California is owned or leased by the out-of-state retailer" to the end of the first sentence in Regulation 1684's current provisions

regarding webpages and Internet services providers, instead of staff's recommended amendments adding "an unrelated third party" to the same sentence.

Mr. Reed Schreiter attended the December 22, 2011, meeting on behalf of PricewaterhouseCoopers LLP. Ms. Narayan attended the meeting on behalf of MuniServices, LLC. During the December 22, 2011, meeting, staff briefly summarized and explained its recommended amendments to Regulation 1684 and noted that staff was considering clarifying its recommended amendments adding subdivision (b)(2) to Regulation 1684. After the meeting, staff received a written comment from MuniServices, LLC that expressed MuniServices, LLC's support for staff's proposed amendments to Regulation 1684. (Exhibit 5.)

#### Staff's Responses to Sutherland Asbill & Brennan LLP's January 13, 2012, Written Comments

Board staff agrees with Sutherland Asbill & Brennan LLP that the recommended amendments adding subdivision (b)(2) to Regulation 1684 would be more clear if the term "physical connection" was replaced with the term "physical presence" from the "physical presence" test established in *National Bellas Hess* (and reaffirmed in *Quill*). In addition, Board staff believes that it would be helpful if subdivision (b)(2) to Regulation 1684 explained how a retailer with a "physical presence" in California can rebut the presumption that it has a "substantial nexus" with and therefore is engaged in business in California (i.e., by establishing that its physical presence in California is so slight that a finding of substantial nexus would not be constitutionally permissible). Board staff also believes that it would be helpful to add an additional subdivision (b)(3) to Regulation 1684 to further clarify that a retailer does not have a physical presence in California solely because the retailer engages in interstate communications with customers in California via common carrier, the United States mail, or interstate telecommunication, including, but not limited to, interstate telephone calls and emails, and that the rebuttable presumption does not apply to a retailer that does not have a physical presence in California. Therefore, Board staff has revised its recommended amendments adding subdivision (b) to Regulation 1684, accordingly.

Board staff further agrees with Sutherland Asbill & Brennan LLP that it would be helpful if the recommended amendments to Regulation 1684 clarified when a person is "in this state" within the meaning of section 6203, subdivision (c)(5)(A), as added by AB 155. In addition, Board staff also believes that it would be helpful if Regulation 1684 further clarified that subdivision (c)(3), as recommended to be added to Regulation 1684, only applies to a retailer when an individual solicits potential customers under the retailer's agreement while the individual is physically present within the boundaries of California, and that such additional clarification would help ensure that subdivision (c)(3) is interpreted and administered consistently with *Tyler Pipe* and *Borders Online*. Therefore, Board staff is now recommending adding a new subdivision (c)(5) to Regulations 1684 to further clarify when an individual is in this state within the meaning of section 6203, subdivision (c)(5)(A), and adding a new subdivision (c)(6) to Regulation 1684 to clarify when subdivision (c)(3) of Regulation 1684 applies. Board staff is also recommending adding new subdivision (c)(8)(B) and (C) to define the term "individual" as referring to a "natural person" and define the term "person" by reference to the definition in section 6005.

Additionally, Board staff agrees with Sutherland Asbill & Brennan LLP that it would be helpful to add examples to Regulation 1684 to illustrate the application of subdivision (c)(3), as recommended to be added to Regulation 1684, and provide examples of "direct and indirect" solicitation within the meaning of subdivision (c)(3). Therefore, Board staff is now recommending adding a new subdivision (c)(9) to Regulation 1684 to provide such examples. Further, Board staff generally agrees with the examples set forth in Sutherland Asbill & Brennan LLP's January 13, 2012, written comments (see Exhibit 4) so long



as the “emails” and “tweets” referenced therein do not constitute solicitations. However, Board staff believes that the operative facts from all three examples can be incorporated into two examples that illustrate the same factual scenarios because staff does not see any substantive distinction between posting an advertisement on a person’s website and posting an advertisement on a person’s facebook.com webpage. Board staff also believes that the combined examples should refer to the use of email, rather than “tweets,” because email is more commonly used presently and the same principles apply in determining whether an email or tweet constitutes a solicitation, as opposed to an advertisement. Furthermore, Board staff believes that the examples should be revised so that they do not refer to real businesses’ actual domain names, such as facebook.com., hiking.com, and itunes.com. Therefore, Board staff is now recommending that the combined examples be added to subdivision (c)(9)(A) and (B) of Regulation 1684 without the references to the actual domain names. In addition, staff believes that it would be helpful to add an additional example that does involve the requisite in-state solicitation activities, so that the example can be used to illustrate “direct and indirect” solicitation activities that can create “affiliate nexus” under subdivision (c)(3), as recommended to be added to Regulation 1684. Therefore, Board staff is now recommending to add such an example to subdivision (c)(9)(C) of Regulation 1684.

Finally, staff agrees with Sutherland Asbill & Brennan LLP’s alternative amendments to the first sentence in Regulation 1684’s current provisions regarding webpages and Internet service providers and staff has incorporated the alternative into its recommended amendments to Regulation 1684. Staff believes that the alternative amendments achieve staff’s intended purpose, which was to amend the provisions regarding webpages and Internet service providers to “recognize that a retailer may establish a substantial nexus with California by having its property, including a computer server, in this state,” as stated in Sutherland Asbill & Brennan LLP’s written comments.

#### **A. Description of Alternative 1**

Approve and authorize publication of Board staff’s recommended amendments to Regulation 1684, as set forth in Exhibit 2. After discussing AB 155 with the interested parties and reviewing the interested parties’ comments, Board staff recommends that Regulation 1684 be amended to:

- Incorporate the new provisions of section 6203, subdivision (c), as amended by AB 155, providing that “retailer engaged in business in this state” means “any retailer that has substantial nexus with this state for purposes of the commerce clause of the United States Constitution and any retailer upon whom federal law permits this state to impose a use tax collection duty,” and incorporate the non-exhaustive examples of retailers with substantial nexus set forth in section 6203, subdivision (c)(1)-(5), as amended by AB 155, including the examples regarding commonly controlled group nexus and affiliate nexus;
- Incorporate the physical presence test established in *National Bellas Hess, Inc. v. Department of Revenue of the State of Illinois* (1967) 386 U.S. 753 (and affirmed in *Quill Corporation v. North Dakota* (1992) 504 U.S. 298) by creating a presumption that a retailer is engaged in business in this state if the retailer has any physical presence in California, and further explain that a retailer may rebut the presumption if the retailer can substantiate that its physical presence is so slight that the United States Constitution prohibits this state from imposing a use tax collection duty on the retailer, that a retailer does not have a physical presence in California solely because the retailer engages in interstate communications with customers in California via common carrier, the United States mail, or interstate telecommunication, including, but not limited to, interstate telephone calls and emails, and that the rebuttable presumption does not apply to a retailer that does not have a physical presence in California;

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- Clarify that services are performed in connection with tangible personal property to be sold by a retailer, within the meaning of section 6203, subdivision (c)(4)'s new commonly controlled group nexus provisions, if the services help the retailer establish or maintain a California market for sales of tangible personal property, and clarify that services are performed in cooperation with a retailer, within the meaning of section 6203, subdivision (c)(4), as added by AB 155, if the retailer and the member of the retailer's commonly controlled group performing the services are working or acting together for a common purpose or benefit;
- Clarify that the phrases "commission or other consideration" and "commissions or other consideration that is based upon sales of tangible personal property," as used in section 6203, subdivision (c)(5)'s new affiliate nexus provisions, refer to any "consideration that is based upon completed sales of tangible personal property, whether referred to as a commission, fee for advertising services, or otherwise," similar to the provisions of New York's affiliate nexus statute, as interpreted by TSB-M-08(3)S;
- Clarify that the determination as to whether a retailer has made the requisite amount of sales to purchasers in California during the preceding 12 month period to be engaged in business in California under section 6203, subdivision (c)(5)'s new affiliate nexus provisions shall be made at the end of each calendar quarter;
- Clarify that, for purposes of section 6203, subdivision (c)(5)'s new affiliate nexus provisions, an individual is in California when the individual is physically present within the boundaries of California and a person other than an individual is in California when there is at least one individual physically present in California on the person's behalf, and further clarify that the affiliate nexus provisions do not apply to a retailer's agreement with any person, unless an individual solicits potential customers under the agreement while the individual is physically present within the boundaries of California, including, but not limited to, an individual who entered into the agreement directly with the retailer, an individual, such as an employee, who is performing activities in California directly for a person that entered into the agreement with the retailer, and any individual who is performing activities in California indirectly for any person who entered into the agreement with the retailer, such as an independent contractor or subcontractor;
- Create a means by which a retailer can effectively establish that its agreement is not the type of agreement that can give rise to affiliate nexus under section 6203, subdivision (c)(5) by utilizing contractual terms and factual certifications that are similar to the contractual terms and factual certifications that a retailer can use to rebut New York's presumption that a retailer has affiliate nexus due to an agreement with a New York resident; and expressly excuse retailers from the requirement to obtain a certification if the person from whom the certification is required is dead, lacks the capacity to make such certification, or cannot reasonably be located by the retailer and there is no evidence to indicate that such person did in fact engage in any prohibited solicitation activities in California at any time during the previous year;
- Define the terms "advertisement," "solicit," and "solicitation" for purposes of applying the new affiliate nexus provisions of section 6203, subdivision (c)(5) by focusing on the general and broad nature of advertising and the more actively targeted nature of soliciting, and conform the definitions for the terms "advertisement," "solicit," "solicitation," "refer" and "referral" to the statements of intent published by Senator Hancock and Assembly Members Blumenfield, Calderon, and Skinner in the September 9, 2011, Assembly Daily Journal;
- Define the term "person" by reference to the definition of "person" set forth in section 6005 and define the term "individual" to mean a "natural person" for purposes of applying the new affiliate nexus provisions of section 6203, subdivision (c)(5);

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- Provide three examples illustrating the application of the new affiliate nexus provisions of section 6203, subdivision (c)(5);
- Recognize that a retailer may establish a substantial nexus with California by having its property, including a computer server, in this state; and
- Provide that the amendments made to Regulation 1684 to implement the nexus-expanding provisions of AB 155 will become operative when new section 6203 becomes operative on September 15, 2012, or January 1, 2013, and shall not have a retroactive effect.

Board staff also recommends that the Board:

- Retain the other current provisions of Regulation 1684 regarding the “taking of orders from customers in this state through a computer telecommunications network” based upon the Board’s 1997 interpretation of *Quill*; and
- Retain the current provisions of Regulation 1684 regarding “warranty and repair services” based upon the Board’s 1997 interpretation of United States Supreme Court cases.

**B. Pros of Alternative 1**

- Board staff’s recommended amendments will ensure that Regulation 1684 is consistent with the provisions of new section 6203, when new section 6203 becomes operative.
- Board staff’s recommended amendments ensure that new section 6203 is interpreted and administered consistently with United States Supreme Court and California court opinions regarding substantial nexus, including, but not limited to, *National Bellas Hess*, *Quill*, *Tyler Pipe*, *Scripto*, *National Geographic Society*, *Current*, and *Borders Online*.
- Board staff’s recommended amendments ensure that new section 6203’s affiliate nexus provisions will be interpreted and administered consistently with the statements of intent published by Senator Hancock and Assembly Members Blumenfield, Calderon, and Skinner in the September 9, 2011, Assembly Daily Journal.
- Board staff’s recommended amendments will also provide guidance to retailers as to whether their activities create a “substantial nexus” with California and require them to register with the Board, and provide more certainty to retailers regarding their new use tax collection obligations before new section 6203 becomes operative.

**C. Cons of Alternative 1**

None.

**D. Statutory or Regulatory Change for Alternative 1**

No statutory change is required. However, staff’s recommendation does require adoption of amendments to Regulation 1684.

**E. Operational Impact of Alternative 1**

Staff will publish the proposed amendments to Regulation 1684 and thereby begin the formal rulemaking process. Staff will also notify taxpayers of the amendments to Regulation 1684 through other outreach efforts.

**F. Administrative Impact of Alternative 1****1. Cost Impact**

The workload associated with publishing the regulation is considered routine. However, the costs associated with the overall implementation of AB 155 are substantive; the Board of Equalization has a pending Budget Change Proposal requesting funds related to enactment of this bill.

**2. Revenue Impact**

None. See Revenue Estimate (Exhibit 1).

**G. Taxpayer/Customer Impact of Alternative 1**

Staff believes the amendments will help taxpayers and staff understand when a retailer is considered to be engaged in business in this state and required to register and collect use tax.

**H. Critical Time Frames of Alternative 1**

Implementation will begin 30 days following approval of the amended regulation by the State Office of Administrative Law. The amended regulation will become operative on September 15, 2012, if a federal law is not enacted on or before July 31, 2012, authorizing the states to require a seller to collect taxes on sales of goods to in-state purchasers without regard to the location of the seller. If a federal law is enacted on or before July 31, 2012, authorizing the states to require a seller to collect taxes on sales of goods to in-state purchasers without regard to the location of the seller, and the state does not, on or before September 14, 2012, elect to implement that law, the amended regulation will become operative on January 1, 2013.

**VII. Alternative 2****A. Description of Alternative 2**

Do not amend Regulation 1684.

**B. Pros of Alternative 2**

The Board would avoid the workload involved with processing and publicizing the amended regulation.

**C. Cons of Alternative 2**

Regulation 1684 will not be entirely consistent with new section 6203, and retailers will not have any additional guidance regarding the Board's interpretation of new section 6203, when new section 6203 becomes operative.

**D. Statutory or Regulatory Change for Alternative 2**

None.

**E. Operational Impact of Alternative 2**

None.

**F. Administrative Impact of Alternative 2****1. Cost Impact**

None.

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**2. Revenue Impact**

None. See Revenue Estimate (Exhibit 1)

**G. Taxpayer/Customer Impact of Alternative 2**

Taxpayers and staff may not understand when retailers are considered engaged in business in this state and required to register and collect use tax.

**H. Critical Time Frames of Alternative 2**

None.

**Preparer/Reviewer Information**

Prepared by: Tax and Fee Programs Division, Legal Department; and Tax Policy Division, Sales and Use Tax Department.

Current as of: February 9, 2012

## REVENUE ESTIMATE

STATE OF CALIFORNIA  
BOARD OF EQUALIZATIONBOARD OF EQUALIZATION  
REVENUE ESTIMATE

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**Engaged in Business in this State – Obligation to Collect Use Tax****Alternative 1 – Staff Recommendation**

Approve and authorize publication of Board staff's recommended amendments to Regulation 1684, as set forth in Exhibit 2. After discussing AB 155 with the interested parties and reviewing the interested parties' comments, Board staff recommends that Regulation 1684 be amended to:

- Incorporate the new provisions of section 6203, subdivision (c), as amended by AB 155 (new subdivision (c)), providing that “retailer engaged in business in this state” means “any retailer that has substantial nexus with this state for purposes of the commerce clause of the United States Constitution and any retailer upon whom federal law permits this state to impose a use tax collection duty”;
- Incorporate the non-exhaustive examples of retailers with substantial nexus set forth in new subdivision (c), including the examples regarding commonly controlled group nexus and affiliate nexus;
- Incorporate the physical presence test established in *National Bellas Hess, Inc. v. Department of Revenue of the State of Illinois* (1967) 386 U.S. 753 (and affirmed in *Quill Corporation v. North Dakota* (1992) 504 U.S. 298) by creating a presumption that a retailer is engaged in business in this state if the retailer has any physical presence in California, and further explain that a retailer may rebut the presumption if the retailer can substantiate that its physical presence is so slight that the United States Constitution prohibits this state from imposing a use tax collection duty on the retailer;
- Explain that a retailer does not have a physical presence in California solely because the retailer engages in interstate communications with customers in California via common carrier, the United States mail, or interstate telecommunication, including, but not limited to, interstate telephone calls and emails, and that the rebuttable presumption does not apply to a retailer that does not have a physical presence in California;
- Clarify that services are performed in connection with tangible personal property to be sold by a retailer if the services help the retailer establish or maintain a California market for sales of tangible personal property, and clarify that services are performed in cooperation with a retailer if the retailer and the member of the retailer's commonly controlled group performing the services are working or acting together for a common purpose or benefit for purposes of the commonly controlled group nexus provisions;

- Clarify that the phrases “commission or other consideration” and “commissions or other consideration that is based upon sales of tangible personal property,” as used in the affiliate nexus provisions, refer to any “consideration that is based upon completed sales of tangible personal property, whether referred to as a commission, fee for advertising services, or otherwise”;
- Clarify that the determination as to whether a retailer has made the requisite amount of sales to purchasers in California during the preceding 12-month period to be engaged in business in California under the affiliate nexus provisions shall be made at the end of each calendar quarter;
- Clarify that an individual is in California when the individual is physically present within the boundaries of California and a person other than an individual is in California when there is at least one individual physically present in California on the person’s behalf for purposes of the affiliate nexus provisions;
- Clarify that the affiliate nexus provisions do not apply to a retailer’s agreement with any person, unless an individual solicits potential customers under the agreement while the individual is physically present within the boundaries of California, including, but not limited to, an individual who entered into the agreement directly with the retailer, an individual, such as an employee, who is performing activities in California directly for a person that entered into the agreement with the retailer, and any individual who is performing activities in California indirectly for any person who entered into the agreement with the retailer, such as an independent contractor or subcontractor;
- Create a means by which a retailer can effectively establish that its agreement is not the type of agreement that can give rise to affiliate nexus by utilizing contractual terms and factual certifications, and expressly excuse retailers from the requirement to obtain a certification if the person from whom the certification is required is dead, lacks the capacity to make such certification, or cannot reasonably be located by the retailer and there is no evidence to indicate that such person did in fact engage in any prohibited solicitation activities in California at any time during the previous year;
- Define the terms “advertisement,” “solicit,” and “solicitation” and conform the definitions for the terms “advertisement,” “solicit,” “solicitation,” “refer” and “referral” to the statements of intent published by Senator Hancock and Assembly Members Blumenfield, Calderon, and Skinner in the September 9, 2011, Assembly Daily Journal (the statements are included in Exhibit 3);
- Define the terms “person” and “individual” for purposes of applying the affiliate nexus provisions;
- Provide three examples illustrating the application of the affiliate nexus provisions;
- Recognize that a retailer may establish a substantial nexus with California by having its property, including a computer server, in this state; and
- Provide that the amendments to Regulation 1684 will become operative when new section 6203 becomes operative on September 15, 2012, or January 1, 2013, and shall not have a retroactive effect.

Board staff also recommends that the Board:

- Retain the other current provisions of Regulation 1684 regarding the “taking of orders from customers in this state through a computer telecommunications network” based upon the Board’s 1997 interpretation of *Quill*; and
- Retain the current provisions of Regulation 1684 regarding “warranty and repair services” based upon the Board’s 1997 interpretation of United States Supreme Court cases.

## **Alternative 2 - Other Alternative Considered**

Do not amend Regulation 1684.

## **Background, Methodology, and Assumptions**

### **Alternative 1 – Staff Recommendation**

There is nothing in staff recommendation that would impact sales and use tax revenue. Staff recommended amendments will ensure that Regulation 1684 is consistent with the provisions of new section 6203, when new section 6203 becomes operative. In addition, staff recommendations will ensure that new section 6203 is interpreted and administered consistently with United States Supreme Court and California court opinions regarding substantial nexus, including, but not limited to, *National Bellas Hess*, *Quill*, *Tyler Pipe*, *Scripto*, *National Geographic Society*, *Current*, and *Borders Online*. Further, staff recommendations will ensure that new section 6203’s affiliate nexus provisions will be interpreted and administered consistently with the statements of intent published by Senator Hancock and Assembly Members Blumenfield, Calderon, and Skinner in the September 9, 2011, Assembly Daily Journal. Finally, staff recommendations will also provide guidance to retailers as to whether their activities create a “substantial nexus” with California and require them to register with the Board, and provide more certainty to retailers regarding their new use tax collection obligations before new section 6203 becomes operative.

### **Alternative 2 – Other Alternative - do not amend Regulation 1684**

There is nothing in alternative 2 that would impact sales and use tax revenue.

## **Revenue Summary**

Alternative 1 – staff recommendation does not have a revenue impact.

Other alternatives considered – Alternative 2 does not have a revenue impact.

## **Preparation**

Mr. Bill Benson, Jr., Research and Statistics Section, Legislative and Research Division, prepared this revenue estimate. Mr. Robert Ingenito, Chief, Research and Statistics Section, Legislative and Research Division, and Ms. Susanne Buehler, Tax Policy Manager, Sales and Use Tax Department, reviewed this revenue estimate. For additional information, please contact Mr. Benson at (916) 445-0840.

Current as of February 10, 2012.



**1684. Collection of Use Tax by Retailers.**

(a) Collection of Use Tax by Retailers Engaged in Business in this State. Retailers engaged in business in this state as defined in §Section 6203 of the Revenue and Taxation Code and making sales of tangible personal property, the storage, use, or other consumption of which is subject to the tax must register with the Board and, at the time of making the sales, or, if the storage, use or other consumption of the tangible personal property is not then taxable, at the time it becomes taxable, collect the tax from the purchaser and give the purchaser a receipt therefor.

(b) General Definition and Rebuttable Presumption.

(1) A retailer is engaged in business in this state as defined in section 6203 of the Revenue and Taxation Code if the retailer has a substantial nexus with this state for purposes of the Commerce Clause (art. I, § 8, cl. 3) of the United States Constitution or federal law otherwise permits this state to impose a use tax collection duty on the retailer. Retailers engaged in business in this state include, but are not limited to, retailers described in subdivision (c).

(2) Except as provided in subdivisions (c) and (d), there is a presumption that a retailer is engaged in business in this state as defined in section 6203 of the Revenue and Taxation Code if the retailer has any physical presence in California. A retailer may rebut the presumption if the retailer can substantiate that its physical presence is so slight that the United States Constitution prohibits this state from imposing a use tax collection duty on the retailer.

(3) A retailer does not have a physical presence in California solely because the retailer engages in interstate communications with customers in California via common carrier, the United States mail, or interstate telecommunication, including, but not limited to, interstate telephone calls and emails. The rebuttable presumption in subdivision (b)(2) does not apply to a retailer that does not have a physical presence in California.

(c) Nonexhaustive Examples of Retailers Engaged in Business in this State.

(1) A retailer is engaged in business in this state as defined in section 6203 of the Revenue and Taxation Code if:

(A) The retailer owns or leases real or tangible personal property, including, but not limited to, a computer server, in California; or

(B) ~~Any~~The retailer derivingderives rentals from a lease of tangible personal property situated in California (under such circumstances this state is a “retailer engaged in business in this state” and the retailer is required to collect the tax at the time rentals are paid by thehis lessee);;

(C) The retailer maintains, occupies, or uses, permanently or temporarily, directly or indirectly, or through a subsidiary, or agent, by whatever name called, an office, place of distribution, sales or sample room or place, warehouse or storage place, or other place of business in California; or

(D) The retailer has a representative, agent, salesperson, canvasser, independent contractor, solicitor, or any other person operating in California on the retailer's behalf, including a person operating in California under the authority of the retailer or its subsidiary, for the purpose of selling, delivering, installing, assembling, or the taking of orders for any tangible personal property, or otherwise establishing or maintaining a market for the retailer's products.

(2) A retailer is engaged in business in this state as defined in section 6203 of the Revenue and Taxation Code if:

(A) The retailer is a member of a commonly controlled group, as defined in Revenue and Taxation Code section 25105; and

(B) The retailer is a member of a combined reporting group, as defined in California Code of Regulations, title 18, section 25106.5, subdivision (b)(3), that includes another member of the retailer's commonly controlled group that, pursuant to an agreement with or in cooperation with the retailer, performs services in California in connection with tangible personal property to be sold by the retailer, including, but not limited to, design and development of tangible personal property sold by the retailer, or the solicitation of sales of tangible personal property on behalf of the retailer. For purposes of this paragraph:

(i) Services are performed in connection with tangible personal property to be sold by a retailer if the services help the retailer establish or maintain a California market for sales of tangible personal property; and

(ii) Services are performed in cooperation with a retailer if the retailer and the member of the retailer's commonly controlled group performing the services are working or acting together for a common purpose or benefit.

(3) A retailer is engaged in business in this state as defined in section 6203 of the Revenue and Taxation Code if the retailer enters into an agreement or agreements under which a person or persons in this state, for a consideration that is based upon completed sales of tangible personal property, whether referred to as a commission, fee for advertising services, or otherwise, directly or indirectly refer potential purchasers of tangible personal property to the retailer, whether by an Internet-based link or an Internet website, or otherwise, provided that:

(A) The total cumulative sales price of all of the tangible personal property the retailer sold to purchasers in California that were referred to the retailer by a person or persons in

California pursuant to an agreement or agreements described above, in the preceding 12 months, is in excess of ten thousand dollars (\$10,000); and

(B) The retailer, within the preceding 12 months, has total cumulative sales of tangible personal property to purchasers in California in excess of one million dollars (\$1,000,000).

The determination as to whether a retailer has made the requisite amount of sales to purchasers in California during the preceding 12-month period shall be made at the end of each calendar quarter. A retailer is not engaged in business in this state pursuant to this paragraph if the total cumulative sales price of all of the tangible personal property the retailer sold to purchasers in California that were referred to the retailer by a person or persons in California pursuant to an agreement or agreements described above, in the preceding 12 months, is not in excess of ten thousand dollars (\$10,000), or if the retailer's total cumulative sales of tangible personal property to purchasers in California were not in excess of one million dollars (\$1,000,000) in the preceding 12 months.

For purposes of this paragraph, the term "retailer" includes an entity affiliated with a retailer within the meaning of Internal Revenue Code section 1504, which defines the term "affiliated group" for federal income tax purposes.

(4) Paragraph (3) does not apply to an agreement under which a retailer purchases advertisements from a person in California, to be delivered on television, radio, in print, on the Internet, or by any other medium, unless:

(A) The advertisement revenue paid to the person in California consists of commissions or other consideration that is based upon completed sales of tangible personal property, and

(B) The person entering into the agreement with the retailer also directly or indirectly solicits potential customers in California through the use of flyers, newsletters, telephone calls, electronic mail, blogs, microblogs, social networking sites, or other means of direct or indirect solicitation specifically targeted at potential customers in this state.

(5) For purposes of paragraph (3):

(A) A person that is an individual is in this state when the person is physically present within the boundaries of California; and

(B) A person other than an individual is in this state when there is at least one individual physically present in California on the person's behalf.

(6) Paragraph (3) does not apply to a retailer's agreement with any person, unless an individual solicits potential customers under the agreement while the individual is physically present within the boundaries of California, including, but not limited to, an individual who entered into the agreement directly with the retailer, an individual, such as an employee, who

is performing activities in California directly for a person that entered into the agreement with the retailer, and any individual who is performing activities in California indirectly for any person who entered into the agreement with the retailer, such as an independent contractor or subcontractor.

(7) Paragraph (3) does not apply if a retailer can demonstrate that all of the persons with whom the retailer has agreements described in paragraph (3) did not directly or indirectly solicit potential customers for the retailer in California. A retailer can demonstrate that an agreement is not an agreement described in paragraph (3) if:

(A) The retailer's agreement:

(i) Prohibits persons operating under the agreement from engaging in any solicitation activities in California that refer potential customers to the retailer including, but not limited to, distributing flyers, coupons, newsletters and other printed promotional materials or electronic equivalents, verbal soliciting (e.g., in-person referrals), initiating telephone calls, and sending e-mails; and

(ii) If the person in California with whom the retailer has an agreement is an organization, such as a club or a non-profit group, the agreement provides that the organization will maintain on its website information alerting its members to the prohibition against each of the solicitation activities described above;

(B) The person or persons operating under the agreement in California certify annually under penalty of perjury that they have not engaged in any prohibited solicitation activities in California at any time during the previous year, and, if the person in California with whom the retailer has an agreement is an organization, the annual certification shall also include a statement from the organization certifying that its website includes information directed at its members alerting them to the prohibition against the solicitation activities described above; and

(C) The retailer accepts the certification or certifications in good faith and the retailer does not know or have reason to know that the certification or certifications are false or fraudulent.

A retailer is excused from the requirement to obtain a certification if the person from whom the certification is required is dead, lacks the capacity to make such certification, or cannot reasonably be located by the retailer and there is no evidence to indicate that such person did in fact engage in any prohibited solicitation activities in California at any time during the previous year.

(8) For purposes of this subdivision:

(A) "Advertisement" means a written, verbal, pictorial, graphic, etc. announcement of goods or services for sale, employing purchased space or time in print or electronic media, which is given to communicate such information to the general public. Online

advertising generated as a result of generic algorithmic functions that is anonymous and passive in nature, such as ads tied to Internet search engines, banner ads, click-through ads, Cost Per Action ads, links to retailers' websites, and similar online advertising services, are advertisements and not solicitations.

(B) "Individual" means a natural person.

(C) "Person" means and includes any individual, firm, partnership, joint venture, limited liability company, association, social club, fraternal organization, corporation, estate, trust, business trust, receiver, assignee for the benefit of creditors, trustee, trustee in bankruptcy, syndicate, the United States, this state, any county, city and county, municipality, district, or other political subdivision of the state, or any other group or combination acting as a unit.

(D) "Solicit" means to communicate directly or indirectly to a specific person or specific persons in California in a manner that is intended to and calculated to incite the person or persons to purchase tangible personal property from a specific retailer or retailers.

(E) "Solicitation" means a direct or indirect communication to a specific person or specific persons done in a manner that is intended to and calculated to incite the person or persons to purchase tangible personal property from a specific retailer or retailers.

(F) "Solicit," "solicitation," "refer," and "referral" do not mean or include online advertising generated as a result of generic algorithmic functions that is anonymous and passive in nature, such as ads tied to Internet search engines, banner ads, click-through ads, Cost Per Action ads, links to retailers' websites, and similar online advertising services.

(9) Examples:

(A) Corporation X is physically located in California and maintains a website at www.corporationx.com. Corporation X enters into agreements with one or more hiking gear and accessories retailers under which Corporation X maintains click-through advertisements or links to each retailer's website on Corporation X's website at www.corporationx.com and Corporation X's webpage at www.socialnetwork.com/corporationx in return for commissions based upon the retailers' completed sales made to customers who click-through the ads or links on Corporation X's website and webpage. Corporation X also posts reviews at www.corporationx.com of the products sold through the click-through ads and links on its website and webpage. However, Corporation X does not engage in any solicitation activities in California that refer potential customers to the retailer or retailers who have click-through ads or links on its website or webpage. Therefore, paragraph (3) does not apply to the agreements between Corporation X and the retailer or retailers who have ads or links on Corporation X's website or webpage.

(B) Same as (A) above, except that Corporation X also enters into an agreement under which Advertising Corporation places advertisements for www.corporationx.com on other businesses' websites and webpages, and mails or emails advertisements for www.corporationx.com to anyone who signs up to receive such advertisements. However, Corporation X does not engage in any solicitation activities in California that refer potential customers to the retailer or retailers who have click-through ads or links on its website or webpage and Advertising Corporation's mailers and emails are advertisements, not solicitations. Therefore, paragraph (3) does not apply to the agreements between Corporation X and the retailer or retailers who have ads or links on Corporation X's website or webpage.

(C) Same as (B) above, except that an individual representative of Corporation X or any other individual acting on behalf of Corporation X, including, but not limited to, an employee or independent contractor of Corporation X or Advertising Corporation, engages in solicitation activities, such as soliciting customers in person, soliciting customers on the telephone, handing out flyers that are solicitations, or sending emails that are solicitations, while physically present in California that refer potential California customers to a retailer who has a click-through ad or link on Corporation X's website or webpage under Corporation X's agreement with that retailer. Therefore, paragraph (3) does apply to Corporation X's agreement with that retailer and that retailer will be required to register with the Board to collect use tax if:

(i) The total cumulative sales price of all of the tangible personal property the retailer sold to purchasers in California that were referred to the retailer by a person or persons in California pursuant to an agreement or agreements described in paragraph (3), in the preceding 12 months, is in excess of ten thousand dollars (\$10,000); and

(ii) The retailer's total cumulative sales of tangible personal property to purchasers in California is in excess of one million dollars (\$1,000,000) in the preceding 12 months.

(d) Exceptions.

(1) Webpages and Internet Service Providers. The use of a computer server on the Internet to create or maintain a World Wide Web page or site by ~~an out-of-state~~ retailer will not be considered a factor in determining whether the retailer has a substantial nexus with California, unless the computer server is located in California and the retailer owns or leases the computer server. No Internet Service Provider, On-line Service Provider, internetwork communication service provider, or other Internet access service provider, or World Wide Web hosting services shall be deemed the agent or representative of any out-of-state retailer as a result of the service provider maintaining or taking orders via a web page or site on a computer server that is physically located in this state.

(2) Warranty and Repair Services. A retailer is not "engaged in business in this state" based solely on its use of a representative or independent contractor in this state for purposes of performing warranty or repair services with respect to tangible personal property sold by the

retailer, provided that the ultimate ownership of the representative or independent contractor so used and the retailer is not substantially similar. For purposes of this paragraph, “ultimate owner” means a stock holder, bond holder, partner, or other person holding an ownership interest.

~~(b)~~3) Convention and Trade Show Activities. For purposes of this subdivision, the term “convention and trade show activity” means any activity of a kind traditionally conducted at conventions, annual meetings, or trade shows, including, but not limited to, any activity one of the purposes of which is to attract persons in an industry generally (without regard to membership in the sponsoring organization) as well as members of the public to the show for the purpose of displaying industry products or to stimulate interest in, and demand for, industry products or services, or to educate persons engaged in the industry in the development of new products and services or new rules and regulations affecting the industry.

Except as provided in this paragraph, a retailer is not “engaged in business in this state” based solely on the retailer's convention and trade show activities provided that:

~~(4)~~A) For the period commencing on January 1, 1998 and ending on December 31, 2000, the retailer, including any of his or her representatives, agents, salespersons, canvassers, independent contractors, or solicitors, does not engage in those convention and trade show activities for more than seven days, in whole or in part, in this state during any 12-month period and did not derive more than ten thousand dollars (\$10,000) of gross income from those activities in this state during the prior calendar year;

~~(2)~~B) For the period commencing on January 1, 2001, the retailer, including any of his or her representatives, agents, salespersons, canvassers, independent contractors, or solicitors, does not engage in those convention and trade show activities for more than fifteen days, in whole or in part, in this state during any 12-month period and did not derive more than one hundred thousand dollars (\$100,000) of net income from those activities in this state during the prior calendar year.

A retailer coming within the provisions of this subdivision is, however, “engaged in business in this state,” and is liable for collection of the applicable use tax, with respect to any sale of tangible personal property occurring at the retailer's convention and trade show activities and with respect to any sale of tangible personal property made pursuant to an order taken at or during those convention and trade show activities.

~~(e)~~e) Retailers Not Engaged in Business in State. Retailers who are not engaged in business in this state may apply for a Certificate of Registration-Use Tax. Holders of such certificates are required to collect tax from purchasers, give receipts therefor, and pay the tax to the Board in the same manner as retailers engaged in business in this state. As used in this regulation, the term “Certificate of Registration-Use Tax” shall include Certificates of Authority to Collect Use Tax issued prior to September 11, 1957.

(~~d~~f) Use Tax Direct Payment Permit Exemption Certificates. Notwithstanding subdivisions (a) and (~~b~~d)(3), a retailer who takes a use tax direct payment exemption certificate in good faith from a person holding a use tax direct payment permit is relieved from the duty of collecting use tax from the issuer on the sale for which the certificate is issued. Such certificate must comply with the requirements of Regulation 1699.6, Use Tax Direct Payment Permits.

(~~e~~g) Tax as Debt. The tax required to be collected by the retailer and any amount unreturned to the customer which is not tax but was collected from the customer under the representation that it was tax constitute debts owed by the retailer to the state.

(~~f~~h) Refunds of Excess Collections. Whenever the Board ascertains that a retailer has collected use tax from a customer in excess of the amount required to be collected or has collected from a customer an amount which was not tax but was represented by the retailer to the customer as being use tax, no refund of such amount shall be made to the retailer even though the retailer has paid the amounts so collected to the state. Section 6901 of the Revenue and Taxation Code requires that any overpayment of use tax be credited or refunded only to the purchaser who made the overpayment.

(i) Amendments. Statutes 2011, chapter 313 (Assem. Bill No. 155), section 3 re-enacted section 6203 of the Revenue and Taxation Code. Chapter 313, section 6, provides that the provisions of section 6203 of the Revenue and Taxation Code as re-enacted by chapter 313, section 3, shall become operative on September 15, 2012, or January 1, 2013. The 2012 amendments to this regulation adopted to implement, interpret, and make specific the provisions of section 6203 of the Revenue and Taxation Code as re-enacted by chapter 313, section 3, shall become operative on the same date as section 6203 of the Revenue and Taxation Code as re-enacted by chapter 313, section 3. Any amendment that implements, interprets and makes specific a use tax collection obligation that did not exist on June 27, 2011, upon becoming operative, shall not have any retroactive effect.

Note: Authority cited: Section 7051, Revenue and Taxation Code. Reference: Sections 6203, 6204, 6226 and 7051.3, Revenue and Taxation Code; and Section 513(d)(3)(A), Internal Revenue Code (26 USC).



**Issue Paper 12-003**

**Submission from Internet Alliance, NetChoice,  
AOL, Inc., Yahoo!, Inc., and Google, Inc.**

**Exhibit 3  
Page 1 of 10**

November 18, 2011

**Via Facsimile (916) 322-4530 and First Class Mail**

Susanne Buehler  
Chief, Tax Policy Division  
Sales and Use Tax Department  
California State Board of Equalization  
P.O. Box 942879  
Sacramento, CA 94279-0092

**Re: Proposed Amendments to Regulation 1684**

Dear Ms. Buehler:

This letter is submitted on behalf of Yahoo!, AOL, Google, NetChoice and the Internet Alliance to provide comments in response to written notification by the State Board of Equalization ("BOE") issued on October 14, 2011 concerning the proposed amendments to Regulation 1684, *Collection of Use Tax by Retailers*. Specifically, we recommend revisions to the amendments to provide clarity and consistency with the legislative intent in enacting ABX128/AB155 as they relate to the Revenue and Taxation Code § 6203(C)(5)(A)-(C).

The proposed amendments to Regulation 1684(c)(5) define the terms "advertisement", "solicit" and "solicitation" for purposes of subdivision (c). As currently stated, the regulation is susceptible to an interpretation broader than that intended by the California legislature. The Assembly Daily Journal for the 2011-12 Regular Session (*see Exhibit 1*) and First Extraordinary Session (*see Exhibit 2*) (September 9, 2011) provided by unanimous consent to print in the journal a statement of legislative intent clarifying the distinction between advertising and activities which rise to the level of solicitation sufficient to meet the definition of a "retailer engaged in business in this state" under Revenue and Taxation Code § 6203.<sup>1</sup>

Valid regulatory provisions must comply with the state Administrative Procedures Act ("Act"). Pursuant to this Act, a regulation must be reviewed for clarity and consistency with the law by the Office of Administrative Law prior to submission to the Secretary of State.<sup>2</sup> A regulation which fails to meet these requirements should not be approved and may be judicially declared invalid.<sup>3</sup>

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<sup>1</sup> Please note that the facsimile transmission of these exhibits only includes the pertinent legislative intent statements, however, the entire documents have been included in the original we are sending via first class mail.

<sup>2</sup> Government Code §§ 11340.5, 11349, 11349.1 and 11349.3. *See also Morning Star Company v. State Board of Equalization*, 132 P.3d 249, 254 (Cal. 2006) and *Naturist Action Committee v. Department of Parks and Recreation*, 96 Cal. Rptr.3d 620, 624 (Cal. Ct. App. 2009).

<sup>3</sup> *Id.*

**Issue Paper 12-003****Submission from Internet Alliance, NetChoice,  
AOL, Inc., Yahoo!, Inc., and Google, Inc.****Exhibit 3  
Page 2 of 10**

The following revisions<sup>4</sup> to the amendments to Regulation 1684 provide clarity and consistency with the statement of legislative intent as it relates to activities which constitute mere advertising and therefore, are not properly categorized as a referral or solicitation:

(3) A retailer is engaged in business in this state as defined in section 6203 of the Revenue and Taxation Code if the retailer enters into an agreement or agreements under which a person or persons in this state, for a commission or other consideration that is based upon completed sales of tangible personal property, directly or indirectly refer potential purchasers of tangible personal property to the retailer, whether by an Internet-based link or an Internet Web site, or otherwise, provided that: (A) The total cumulative sales price of all of the tangible personal property the retailer sold to purchasers in California that were referred to the retailer by a person or persons in California pursuant to an agreement or agreements described above, in the preceding 12 months, is in excess of ten thousand dollars (\$10,000); and (B) The retailer, within the preceding 12 months, has total cumulative sales of tangible personal property to purchasers in California in excess of one million dollars (\$1,000,000).

The determination as to whether a retailer has made the requisite amount of sales to purchasers in California during the preceding 12 month period shall be made at the end of each calendar quarter. A retailer is not engaged in business in this state pursuant to this paragraph if the total cumulative sales price of all of the tangible personal property the retailer sold to purchasers in California that were referred to the retailer by a person or persons in California pursuant to an agreement or agreements described above, in the preceding 12 months, is not in excess of ten thousand dollars (\$10,000), or if the retailer's total cumulative sales of tangible personal property to purchasers in California were not in excess of one million dollars (\$1,000,000) in the preceding 12 months.

For purposes of this paragraph, the terms "refer" or "referral" does not include online advertising, including those ads tied to Internet search engines, banner ads, click-through ads, Cost Per Action ads, links to retailer websites and similar online advertising services.

For purposes of this paragraph, the term "retailer" includes an entity affiliated with a retailer within the meaning of Internal Revenue Code section 1504, which defines the term "affiliated group" for federal income tax purposes. However, this paragraph does not apply to an agreement under which a retailer purchases advertisements from a person in

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<sup>4</sup> Additional language is underlined.

**Issue Paper 12-003**

**Submission from Internet Alliance, NetChoice,  
AOL, Inc., Yahoo!, Inc., and Google, Inc.**

**Exhibit 3  
Page 3 of 10**

California, to be delivered on television, radio, in print, on the Internet, or by any other medium, unless (A) the advertisement revenue paid to the person in California consists of commissions or other consideration that is based upon completed sales of tangible personal property and (B) the person entering into the agreement with the retailer also directly or indirectly solicits potential customers in California through the use of flyers, newsletters, telephone calls, electronic mail, blogs, microblogs, social networking sites, or other means of direct or indirect solicitation specifically targeted at potential customers in this state.

...

(5) For purposes of this subdivision:

(A) "Advertisement" means a written, verbal, pictorial, graphic, etc. announcement of goods or services for sale, employing purchased space or time in print or electronic media, which is given to communicate such information to the general public;

(B) "Solicit" means to communicate directly or indirectly to a specific person or specific persons in California in a manner that is intended to and calculated to incite the person or persons to purchase tangible personal property from a specific retailer or retailers. The term solicit does not include online advertising, including those ads tied to Internet search engines, banner ads, click-through ads, Cost Per Action ads, links to retailer websites and similar online advertising services; and

(C) "Solicitation" means a direct or indirect communication to a specific person or specific persons done in a manner that is intended to and calculated to incite the person or persons to purchase tangible personal property for a specific retailer or retailers. The term solicitation does not include online advertising, including those ads tied to Internet search engines, banner ads, click-through ads, Cost Per Action ads, links to retailer websites and similar online advertising services.

**Issue Paper 12-003****Submission from Internet Alliance, NetChoice,  
AOL, Inc., Yahoo!, Inc., and Google, Inc.****Exhibit 3  
Page 4 of 10**

We appreciate this opportunity to comment on the proposed amendments to Regulation 1684. Please don't hesitate to contact us if you have any questions or would like additional information.

Very truly yours,

Tammy Cota, Executive Director  
Internet Alliance  
1615 L Street, NW, Suite 1100  
Washington, DC 20036  
tammy@internetalliance.org

Steve Delbianco  
Executive Director, NetChoice  
1413 K Street, NW  
12<sup>th</sup> Floor  
Washington, DC 20005  
sdelbianco@netchoice.org

Will Castleberry, Vice President, Public Policy  
AOL, Inc.  
1050 K Street, NW  
Suite 340  
Washington, DC 20001  
w.castleberry@teamaol.com

Bill Ashworth, Sr. Director, State Government Affairs  
Yahoo!, Inc.  
101 Constitution Avenue, NW  
Suite 800W  
Washington, DC 20001  
billashw@yahoo-inc.com

Leslie Miller, Senior Manager, Public Policy  
Google, Inc.  
1600 Amphitheatre Parkway  
Mountain View, CA 94043  
lfmiller@google.com

Enclosure

**Issue Paper 12-003**

**Submission from Internet Alliance, NetChoice,  
AOL, Inc., Yahoo!, Inc., and Google, Inc.**

**Exhibit 3**

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# **EXHIBIT 1**

**Issue Paper 12-003****Submission from Internet Alliance, NetChoice,  
AOL, Inc., Yahoo!, Inc., and Google, Inc.****Exhibit 3  
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Sept. 9, 2011

ASSEMBLY JOURNAL

3161

CALIFORNIA LEGISLATURE

2011-12 REGULAR SESSION

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# ASSEMBLY DAILY JOURNAL

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Friday, September 9, 2011

ONE HUNDRED TWENTY-SEVENTH SESSION DAY

TWO HUNDRED SEVENTY-EIGHTH CALENDAR DAY

AT SACRAMENTO, CALIFORNIA



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NOTE: Official record of roll call votes; all amendments considered by the Assembly on this day are on file with the Chief Clerk of the Assembly and available on request. A list of all measures amended and on which amendments were offered is shown on the final page of this day's Assembly Journal.

(Please direct any inquiries and report any omissions or errors to Minute Clerk: Phone 916-319-2360)

**Issue Paper 12-003**

**Submission from Internet Alliance, NetChoice,  
AOL, Inc., Yahoo!, Inc., and Google, Inc.**

**Exhibit 3  
Page 7 of 10**

Sept. 10, 2011

ASSEMBLY JOURNAL

3261

**Legislative Intent—Assembly Bill No. 155**

September 9, 2011

*E. Dotson Wilson  
Chief Clerk of the Assembly  
State Capitol, Room 3196  
Sacramento, California*

**RE: Letter to the Journal—Assembly Bill 155**

Dear Mr. Wilson: We respectfully submit this Letter to the Journal to document the legislative intent of AB 155, passed by this body in 2011.

As the authors and co-author of AB 155, we are writing to clarify our intent with regard to Revenue and Taxation Code Section 6203(c)(5)(A)–(C). These provisions were meant to draw a clear line between activities that are “mere advertising” versus more sufficiently meaningful in-state activity that should properly be characterized as “soliciting business” for purposes of meeting the definition of a “retailer engaged in business in this state.” Given the evolving nature of online advertising, and the anonymous manner in which it may be delivered to online customers, it is important to note that, in isolation, online advertising, including those ads tied to Internet search engines, banner ads, click-through ads, Cost Per Action ads, links to retailer websites and similar online advertising services should not be considered a “referral” under subparagraph 5(A), nor “direct or indirect solicitation specifically targeted at potential customers in this state” under subparagraph 5(C). Those types of advertising services are generated as a result of generic algorithmic functions and are anonymous and passive in nature and thus do not rise to the level of referring or soliciting business. Agreements for such advertising services are not covered, unless the person entering the agreement also engages in other activities on behalf of the retailer in this state—such as sending flyers or making phone calls—that are specifically targeted at customers in this state.

Thank you for the opportunity to clarify this matter.

Sincerely,

CHARLES M. CALDERON, Assembly Member  
Fifty-eighth District

NANCY SKINNER, Assembly Member  
Fourteenth District

LONI HANCOCK, State Senator  
Ninth District

# **EXHIBIT 2**



**Issue Paper 12-003**

**Submission from Internet Alliance, NetChoice,  
AOL, Inc., Yahoo!, Inc., and Google, Inc.**

**Exhibit 3  
Page 9 of 10**

Sept. 9, 2011

ASSEMBLY JOURNAL

327

CALIFORNIA LEGISLATURE

2011-12 FIRST EXTRAORDINARY SESSION

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# ASSEMBLY DAILY JOURNAL

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**Friday, September 9, 2011****SIXTY-FOURTH SESSION DAY****TWO HUNDRED SEVENTY-EIGHTH CALENDAR DAY****AT SACRAMENTO, CALIFORNIA**

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**NOTE:** Official record of roll call votes; all amendments considered by the Assembly on this day are on file with the Chief Clerk of the Assembly and available on request. A list of all measures amended and on which amendments were offered is shown on the final page of this day's Assembly Journal.

(Please direct any inquiries and report any omissions or errors to Minute Clerk; Phone 916-319-2360)

**Issue Paper 12-003**

**Submission from Internet Alliance, NetChoice,  
AOL, Inc., Yahoo!, Inc., and Google, Inc.**

**Exhibit 3****Page 10 of 10**

Sept. 10, 2011

ASSEMBLY JOURNAL

337

**REQUEST FOR UNANIMOUS CONSENT TO PRINT IN JOURNAL**

Assembly Member Charles Calderon was granted unanimous consent that the following statement of legislative intent be printed in the Journal:

**Legislative Intent—Assembly Bill No. 28**

September 9, 2011

*E. Dotson Wilson  
Chief Clerk of the Assembly  
State Capitol, Room 3196  
Sacramento, California*

RE: Letter to the Journal—Assembly Bill X1 28  
(Chapter 7, Statutes of 2011)

Dear Mr. Wilson: We respectfully submit this Letter to the Journal to document the legislative intent of my ABX1 28, passed by this body in 2011 and the original bill AB 153 upon which ABX1 28 was based.

As authors of ABX1 28 and AB 153, respectively, we are writing to clarify our intent with regard to Revenue and Taxation Code Section 6203(c)(5)(A)–(C). These provisions were meant to draw a clear line between activities that are “mere advertising” versus more sufficiently meaningful in-state activity that should properly be characterized as “soliciting business” for purposes of meeting the definition of a “retailer engaged in business in this state.” Given the evolving nature of online advertising, and the anonymous manner in which it may be delivered to online customers, it is important to note that, in isolation, online advertising, including those ads tied to Internet search engines, banner ads, click-through ads, Cost Per Action ads, links to retailer websites and similar online advertising services should not be considered a “referral” under subparagraph 5(A), nor “direct or indirect solicitation specifically targeted at potential customers in this state” under subparagraph 5(C). Those types of advertising services are generated as a result of generic algorithmic functions and are anonymous and passive in nature and thus do not rise to the level of referring or soliciting business. Agreements for such advertising services are not covered, unless the person entering the agreement also engages in other activities on behalf of the retailer in this state—such as sending flyers or making phone calls—that are specifically targeted at customers in this state.

Thank you for the opportunity to clarify this matter.

Sincerely,

BOB BLUMENFIELD, Assembly Member  
Fortieth District  
NANCY SKINNER, Assembly Member  
Fourteenth District

**MESSAGES FROM THE SENATE**

Senate Chamber, September 10, 2011

Mr. Speaker: I am directed to inform your honorable body that the Senate on this day adopted:

Senate Concurrent Resolution No. 2

GREGORY P. SCHMIDT, Secretary of the Senate  
By Bernadette McNulty, Assistant Secretary



1275 Pennsylvania Avenue, NW  
Washington, DC 20004-2415  
202.383.0100 Fax 202.637.3593  
www.sutherland.com

ATLANTA  
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January 13, 2012

Ms. Susanne Buehler, Chief  
Tax Policy Division/Sales and Use Tax  
California State Board of Equalization  
450 N Street  
Sacramento, California 94279-0092

Re: Comments on Proposed Amendments to Regulation 1684  
Collection of Use Tax by Retailers

Dear Ms. Buehler:

We write to offer comments on the Board of Equalization's ("BOE") proposed amendments to Sales and Use Tax Regulation 1684 ("Proposed Regulation") as set forth in the Second Discussion Paper, dated December 9, 2011. We appreciate BOE staff's response to our comments, dated November 18, 2011, and have provided additional comments as set forth below. We welcome the opportunity to discuss our comments with you at any time.

**1. Clarify "Person or Persons in this State" As Referenced in The Affiliate Nexus (Click-Through Nexus) Provision.**

AB 155 modifies the definition of "retailer engaged in business in this state" by adding 6203(c)(5) to include:

- (A) Any retailer entering into an agreement or agreements under which a *person or persons in this state*, for a commission or other consideration, directly or indirectly refer potential purchasers of tangible personal property to the retailer, whether by an Internet-based link or an Internet Web site, or otherwise, provided that both of the following conditions are met:
  - (i) The total cumulative sales price from all of the retailer's sales, within the preceding 12 months, of tangible personal property to purchasers in this state that are referred pursuant to all of those agreements with a person or persons in this state, is in excess of ten thousand dollars (\$10,000).

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- (ii) The retailer, within the preceding 12 months, has total cumulative sales of tangible personal property to purchasers in this state in excess of five hundred thousand dollars (\$500,000).

(emphasis added).

In our comments dated November 18, 2011, we suggested that “a person or persons in this state” should be defined. We further suggested that the BOE should clarify that “a person in this state” refers to an individual that is a California resident or a business legal entity that is commercially domiciled or headquartered in California. We also suggested that the Proposed Regulation make clear that “a person in this state” must be limited to those in-state persons who are performing activities to establish or maintain *a California market*.

We understand that the BOE staff was not inclined to adopt our recommendations and specifically stated in its December 9, 2011 response that “*an individual does not need to be a resident of California and a legal entity does not need to be headquartered or domiciled in California in order to perform services in this state.*” As a result of the BOE’s response, we request that the BOE implement two clarifications: (1) provide another objective measurement for determining whether a person is “in this state”; and (2) make clear that “a person in this state” must be referring potential California purchasers of tangible personal property to retailer. For example, with respect to the first requirement, if the residence or business address of the person that the retailer enters into an agreement with is in this state then the person would be presumed to be “in this state” as required by this provision. Without such an objective mechanism, retailers may be unable to verify whether the person performs service in this state as was noted by the BOE. In addition, with respect to the second clarification, the U.S. Supreme Court has held that in order for an agent or representative to establish nexus for an out-of-state retailer, the agent or representative must be establishing or maintaining a market *in the state*. Thus, it should be clarified that the “person in this state” must be conducting activities in California that establish or maintain a market for the retailer in California.

**2. Clarify “Direct or Indirect” Solicitation As Referenced in The Affiliate Nexus (Click-Through Nexus) Provision.**

AB 155 also provides certain exceptions to the new definition of “retailer engaged in business in this state” set forth in 6203(c)(5)(A) to include:

- (B) An agreement under which a retailer purchases advertisements from a person or persons in this state, to be delivered on television, radio, in print, on the Internet, or by any other medium, is not an agreement described in subparagraph (A), unless the advertisement revenue paid to the person or persons in this state consists of commissions or other consideration that is based upon sales of tangible personal property.

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- (C) Notwithstanding subparagraph (B), an agreement under which a retailer engages a person in this state to place an advertisement on an Internet Web site operated by that person, or operated by another person in this state, is not an agreement described in subparagraph (A), unless the person entering the agreement with the retailer also directly or indirectly solicits potential customers in this state through use of flyers, newsletters, telephone calls, electronic mail, blogs, microblogs, social networking sites, or other means of *direct or indirect* solicitation specifically targeted at potential customers in this state.
- (D) For purposes of this paragraph, "retailer" includes an entity affiliated with a retailer within the meaning of Section 1504 of the Internal Revenue Code.

(emphasis added).

The BOE staff has indicated that it disagrees that the words "directly or indirectly" require further clarification. Thus, Sutherland requests that the BOE staff provide additional examples to illustrate when a solicitation is "indirect."

The following examples are suggested:

Example 1. Hiking.com contains links to retailers' websites that allow customers to click through to the website to purchase hiking gear and accessories. Hiking.com receives a commission for each click-through that results in a completed sale based on an agreement with each retailer. Hiking.com posts reviews via the Internet of the various products sold via the links. Hiking.com does not solicit customers for these retailers, and therefore will not create nexus for the retailers.

Example 2. Hiking.com contains links to retailers' websites that allow customers to click through to the website to purchase hiking gear and accessories. Hiking.com receives a commission for each click-through that results in a completed sale based on an agreement with each retailer. Hiking.com posts reviews via the Internet of the various products sold via the links. In addition, Hiking.com also post advertisements and messages on Facebook and sends "tweets" via Twitter regarding the various products sold via the links. Hiking.com does not solicit customers for these retailers, and therefore will not create nexus for the retailers.

Example 3. Tunes.com allows customers to listen to music samples and offers suggestions regarding which songs customers should purchase based on the customers' stated musical preferences. Tunes.com posts a variety of click-through links to retailers' websites offering for sale music described on the Tunes.com website, and receives a commission from those retailers based on completed sales. Tunes.com does not solicit customers for these retailers; however, Tunes.com has advertising agreements with other unrelated third parties to

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send emails to potential customers promoting the retailers' websites offerings. Tunes.com does not solicit customers for these retailers and therefore will not create nexus for the retailers.

### **3. Remove Rebuttable Presumption in Proposed Regulation 1684(b)(2)**

The Proposed Regulation adds section (b)(2) which provides:

Except as provided in subdivisions (c) and (d), there is a rebuttable presumption that a retailer is engaged in business in this state as defined in 6203 of the Revenue and Taxation Code if the retailer has any physical connection to California besides a connection with customers in California that is exclusively by means of interstate commerce, such as by common carrier, the United States mail, or interstate telecommunication.

As stated in Sutherland's comments dated November 18, 2011, the BOE should strike language creating a rebuttable presumption that a retailer is doing business in this state "if the retailer has any physical connection to California besides a connection with customers that is exclusively by means of interstate commerce." Prop. Reg. 1684(b)(2). As stated previously, the rebuttable presumption is beyond the scope of the statute. *The statute does not contain a presumption.* Furthermore, a retailer should not be presumed to be doing business in this state when it lacks sufficient connection with this state to justify imposition of sales or use tax under the Commerce and Due Process Clauses of the United States Constitution. In cases where a sufficient connection is not evident, the burden should rest with California to show it has jurisdiction to impose a sales and use tax rather than with the taxpayer to disprove jurisdiction.

In addition, Sutherland maintains that "any physical connection to California" is insufficient to satisfy the Commerce Clause's substantial nexus standard under *Nat'l Geographic Society v. Calif. Bd. of Equalization*, 430 U.S. 551, 556 (1977). However, even if Subsection (b)(2) met this standard, the term "physical connection" requires further clarification. For example, use of a third party contractor to perform warranty and repair work arguably creates a physical connection to California and is not a connection that is "exclusively by means of interstate commerce," but the Board has determined that this level of connection is insufficient to create substantial nexus for the out-of-state retailer engaging the third party contractor. The term "physical connection" should be changed to "physical presence" to be consistent with the *Quill* physical presence standard. The use of the term "physical presence" rather than "physical connection" is consistent with BOE staff's First and Second Discussion Papers, which reaffirm "[i]n the absence of congressional action, the bright-line rule established in *National Bellas Hess, Inc. v. Department of Revenue of the State of Illinois*, 386 U.S. 753 (1967), that a retailer must have a 'physical presence' in a taxing state in order for that state to impose a use tax collection obligation on the retailer is still applicable today." (citations omitted) First Discussion Paper at 4; Second Discussion Paper at 4.

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**4. Revise Amendments to Proposed Regulation 1684(d)(1)– Web Pages and Internet Service Providers**

The Proposed Regulation modifies the “Web Pages and Internet Service Providers” exception set forth in (d)(1) to indicate that only use of an “unrelated third party’s” computer server on the Internet is excepted. In its November 18, 2011 letter, Sutherland indicated that the BOE’s proposed revision would attempt to limit California’s existing computer server exemption set forth in the Proposed Regulation to use of an unrelated third party server and that such a change would be in violation of the federal Internet Tax Freedom Act (“ITFA”).

In response to Sutherland’s November 18, 2011 comments regarding the Proposed Regulation, BOE staff indicated: “the recommended amendments merely recognize that a retailer may establish a substantial nexus with California by having its property, including a computer server, in this state.” Second Discussion Paper at 26. Given the BOE staff’s stated intent, we recommend the following amendments to Subsection (d)(1):

(1) Web Pages and Internet Service Providers. The use of a computer server on the Internet to create or maintain a World Wide Web page or site by an out-of-state retailer will not be considered a factor in determining whether the retailer has a substantial nexus with California, unless the computer server located in California is owned or leased by the out-of-state retailer. No Internet Service Provider, On-line Service Provider, internetwork communication service provider, or other Internet access service provider, or World Wide Web hosting services shall be deemed the agent or representative of any out-of-state retailer as a result of the service provider maintaining or taking orders via a web page or site on a computer server that is physically located in this state.

We appreciate your consideration of our comments.

Sincerely,



Michele Pielsticker



MuniServices, LLC.

1400 K Street, Suite 212 Sacramento, California 95814

Phone: 800.800.8181 Fax: 916.441.4688

www.MuniServices.com

January 13, 2012

Ms. Susanne Buehler, Chief  
Tax Policy Division  
Board of Equalization  
450 N Street  
P.O. Box 942879  
Sacramento, CA 94279-0092

Re: Interested party comments: Proposed State Board of Equalization Regulation 1684, *Collection of Use Tax by Retailers*

Dear Ms. Buehler:

MuniServices received and reviewed the Second Discussion Paper for proposed Regulation 1684 to implement the provisions of AB 155 (Chapter 313, Statutes of 2011). AB 155 expands the definition of "retailer engaged in business in this state." We continue to be pleased with the direction of the proposed regulation.

As previously discussed, MuniServices has been a partner of local government for over 30 years and has always encouraged and supported efforts to enforce the law for the collection and remittance of use taxes. MuniServices supported AB 155; this year we will support H.R. 3179 (co-authored by California Congresswoman Jackie Speier), the Marketplace Equity Act of 2011. As currently drafted the bill would level the playing field between out-of-state online retailers and in-state brick-and-mortar stores by providing a framework for states to require that out-of-state sellers collect and report the taxes due on their retail sales. H.R. 3179 would have less impact on current sales tax law and could be implemented sooner and without any negative impact to current sales tax law.

We look forward to working with Board Staff on the shaping of Regulation 1684, and the subsequent collection of use taxes. The estimates of unpaid taxes at approximately \$1.1 billion annually, with approximately \$200 million from online purchases are much needed revenues for the State and local governments to provide basic services.

Sincerely,

A handwritten signature in black ink that reads 'Brenda Narayan'. The signature is fluid and cursive, with the first name 'Brenda' being more prominent.

Brenda Narayan  
Director of Government Relations